94th Congress } JOINT COMMITTEE PRINT
2d Session

BROADENING THE OWNERSHIP OF NEW CAPITAL: ESOPs AND OTHER ALTERNATIVES

A STAFF STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

JUNE 17, 1976

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
72-172 WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washintgton, D.C. 20402 - Price 80 cents
There is a minimum charge of $1.00 for each mail order.

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

HUBERT H. HUMPHREY, Minnesota, *Chairman*
RICHARD BOLLING, Missouri, *Vice Chairman*

SENATE

JOHN SPARKMAN, Alabama
WILLIAM PROXMIRE, Wisconsin
ABRAHAM RIBICOFF, Connecticut
LLOYD M. BENTSEN, Jr., Texas
EDWARD M. KENNEDY, Massachusetts
JACOB K. JAVITS, New York
CHARLES H. PERCY, Illinois
ROBERT TAFT, Jr., Ohio
PAUL J. FANNIN, Arizona

HOUSE OF REPRESENTATIVES

HENRY S. REUSS, Wisconsin
WILLIAM S. MOORHEAD, Pennsylvania
LEE H. HAMILTON, Indiana
GILLIS W. LONG, Louisiana
OTIS G. PIKE, New York
CLARENCE J. BROWN, Ohio
GARRY BROWN, Michigan
MARGARET M. HECKLER, Massachusetts
JOHN H. ROUSSELOT, California

JOHN R. STARK, *Executive Director*

SENIOR STAFF ECONOMISTS

WILLIAM A. COX
JERRY J. JASINOWSKI
JOHN R. KARLIK
COURTENAY M. SLATER

RICHARD F. KAUFMAN, *General Counsel*

ECONOMISTS

WILLIAM R. BUECHNER
ROBERT D. HAMRIN
RALPH L. SCHLOSSTEIN
SARAH JACKSON
GEORGE R. TYLER
LUCY A. FALCONE
L. DOUGLAS LEE
LARRY YUSPEH

MINORITY

CHARLES H. BRADFORD (Senior Economist)

GEORGE D. KRUMBHAAR, Jr. (Counsel)
M. CATHERINE MILLER (Economist)

LETTERS OF TRANSMITTAL

June 14, 1976.

To the Members of the Joint Economic Committee: Transmitted herewith for the use of the Joint Economic Committee and other Members of Congress is a staff study entitled "Broadening the Ownership of New Capital: ESOPs and Other Alternatives." Such plans are of great current interest in the corporate community and have been included in four pieces of legislation during the past 30 months.

In addition to providing a comprehensive examination of ESOPs, the study discusses several major alternative methods which could help achieve a primary new national economic goal that was expressed in the 1976 Annual Report of the Joint Economic Committee: To broaden the ownership of new capital.

The study was prepared by Dr. Robert Hamrin of the Committee staff.

The views expressed in the study do not necessarily represent the views of the Members of this Committee or the Committee staff.

Hubert H. Humphrey,
Chairman, Joint Economic Committee.

June 10, 1976

Hon. Hubert H. Humphrey,
Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.

Dear Mr. Chairman: Transmitted herewith is a staff study entitled "Broadening the Ownership of New Capital: ESOPs and Other Alternatives."

The study presents the most recent statistics on personal wealth, depicting the concentration that continues to characterize U.S. wealth holdings. It then proceeds to examine four major alternative measures for broadening stock ownership in order to diminish this concentration and to enable more individuals to share more fully and directly in America's economic growth, as recommended in the 1976 Annual Report of the Joint Economic Committee.

Two of these, the Wage Earner's Investment Funds and the Employe Stock Ownership Plans are currently in use. The other two, the Capital Formation Plan and the Financed Capitalist Plan, are hypothetical comprehensive systems directed at increased stock ownership for all lower and middle income Americans.

The study was prepared by Dr. Robert Hamrin of the Committee staff and draws upon Committee studies and hearings in reaching a number of conclusions.

The views expressed in the study do not necessarily represent the views of the members of the Committee or the Committee staff.

John R. Stark,
Executive Director,
Joint Economic Committee.

CONTENTS

SUMMARY AND CONCLUSIONS

Wealth in the United States has been and remains highly concentrated, with the richest 1.0 percent of the population in 1972 owning nearly one-fourth of all personally held assets. At the other end of the income spectrum, the majority of American households that year had a financial net worth less than $10,000 and nearly one out of every eight families had virtually no net worth. Recognizing that the concentrated ownership of wealth and the highly skewed distribution of income which stems from it will not be substantially altered without explicit action on the problem, this report concludes that the ownership of new capital should be broadened, as first recommended in the 1976 Annual Report of the Joint Economic Committee which stated:

> To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership. Congress also should request from the Administration a quadrennial report on the ownership of wealth in this country which would assist in evaluating how successfully the base of wealth was being broadened over time.

Corporate stock should be chosen as the target asset for achieving this goal since it can be easily and widely distributed, it is a highly significant factor contributing to personal wealth, ranking second for all individuals but dominating the assets held by the rich, and it is the most direct way for Americans to share in the growth of their country. There is also the additional factor that the corporate sector and the economy as a whole should benefit through the more efficient capital markets resulting from increased equity financing. Specific facts and arguments presented in the report support this line of reasoning.

The disturbing facts and trends concerning individuals' stockholding which should be reversed or ameliorated through programs to provide opportunities for lower and middle-income Americans to acquire stock are as follows: (a) The number of individual stockholders is decreasing; (b) employed individuals hold less than ½ of the market value of outstanding stock; (c) most of the outstanding stock is owned by a very small number of extremely wealthy individuals; (d) concentration in stockholdings means that most Americans are precluded from obtaining a significant ownership share in America's corporations and also that effective control over virtually all corporate assets rests in the hands of a small proportion of the population.

The following findings support the argument that current corporate financing and equity ownership could be benefited through a program that would stimulate the issuance of new equities which would go primarily to individuals. First, the contribution which stocks have made to funding new capital formation has decreased considerably throughout this century, reaching a level as low as 2 percent in recent years. Since retained earnings have maintained a fairly constant share

of corporate income, corporations have had to rely increasingly on debt to a degree, especially during the past decade, that cannot be sustained and may not be beneficial for the economy.

The role of institutions, particularly pension funds, as holders of stock has increased dramatically and will continue to do so. Over the next decade, pension funds will increase their ownership share of outstanding stock from nearly 20 percent at present to around 50 percent. Thus, these funds have been, and will continue to be for at least 10 to 15 years, an extremely significant source of funds for new capital formation. This fact, however, carries with it some potentially disturbing implications: (a) capital market decisions will be increasingly transferred to professional asset managers who are inherently and by mandate more conservative in placing their investments; and (b) by the late 1980s, it is possible that due to changing demographic trends they will become pure transfer mechanisms, perhaps leading to dissaving.

There are four major alternative methods for broadening the ownership of new capital examined in this report. Two which are already in practice, Wage Earners' Investment Funds (WEIFs) and Employee Stock Ownership Plans (ESOPs), center on increased stock ownership only for employees of corporations. The other two, the capital formation plan and the financial capitalist plan, are hypothetical comprehensive systems directed at increased stock ownership for all lower and middle-income Americans.

The WEIF concept as practiced in Western Europe is concerned with giving labor not only a share of the capital gains accruing to stockholders but also the codetermination rights inherent in stock ownership. In a WEIF system, all corporations contribute a fraction of their wage bill or profits to a fund belonging to the employees. Fund certificates given to the employees are redeemable in cash after a given number of years in an amount that includes all capital gains and dividends made during their holding of the certificates. A system of competing funds, rather than one that is confined to a certain industry or geographic region, is best because there is the greatest scope for maximizing the rate of return as risk can be spread among firms, industries, and regions.

There is some disadvantage to the WEIF system. Depending on the way it is structured, it could interfere with the capital markets by (1) hindering the free flow of capital; (2) not always insisting on maximizing the return on investments and thereby unduly favoring less capital-intensive, less rapidly growing and less well-managed firms, and (3) narrowing the oportunities for self-financing.

The capital formation plan aims to stimulate the greater use of equity financing and to encourage all low and middle-income individuals, not just employees, to purchase stock through tax incentives. Specifically, all persons with annual incomes below $20,000 could take either a deduction or 10-percent tax credit for the amount they invest in corporate stock up to $3,000. To encourage firms to engage in greater equity financing, a split rate corporate income tax schedule would be effected which taxes earnings that are retained much more heavily than those that are distributed. To encourage corporations to sell their new equity issues to the capital formation funds from which the indi-

viduals buy their diversified stock portfolio, dividends paid on shares sold to a CFF would be fully deductible. The revenue loss to the Treasury, though large in the early years, would be gradually offset by the increased income taxes on dividends received and also by the reduction in the amount of interest deductions taken by companies.

The financed capitalist plan as proposed by Louis Kelso calls for the greatest structural changes in the economic system. All capital expenditures would be paid for by issuance of common stock which is made available to the financed capitalist plan. All earnings for participating corporations (except for reasonable reserves) would be paid out as dividends which would be tax-deductible. Those households selected to participate in the plan could purchase a given amount of stock of these corporations through a commercial bank loan on a nonrecourse self-liquidating basis (the borrower incurs no personal liability and the loan is to be repaid from dividends received). These loans would be guaranteed by a capital diffusion insurance corporation and could be rediscounted by the Federal Reserve System.

Each household receives a diversified portfolio of their own choosing. This stock portfolio certificate is held in escrow until the principal and interest have been repaid (an estimated 7-year average). At this time, the households would have complete and direct ownership of the stock.

The basic criticism of this plan is not so much one of substance but of scope. It simply is too ambitious and imposes revolutionary changes on the foundations of the economic system in one fell swoop. Since the system simply could not accommodate these changes, economic stabilization would be seriously jeopardized and financial markets would be in a period of disarray. However, since the basic thrust of the plan has much merit, it should not be dismissed but simply scaled down. Rather than financing all new capital investment by new equities made available to the plan, some percentage should be specified which could be increased over time if desired. Relatedly, some percentage of earnings, rather than all earnings, would be paid out as dividends which again could increase over time. The key change in substance would be to eliminate the rediscounting procedure which is no longer necessary under a limited approach.

With regard to these three plans, the following conclusion is drawn:

There are numerous ways to achieve the goal of broadened ownership of new capital. Since this is a goal for all Americans and not just employees of corporations, serious consideration should be given to plans that are open to all individuals so that anyone desiring to purchase stock under special beneficial provisions may do so up to a specified ceiling. The plan should also provide incentives for firms to finance their future capital formation through issuance of new shares of stock as this would serve two purposes: (1) It would enhance economy-wide efficiency since funds channeled through the capital markets would be allocated to the areas with the highest rates of return; and (2) it would help insure that a significant amount of new stock would be continually available for purchase by individuals. The capital formation plan and the financial capitalist plans are comprehensive programs containing specific provisions to help meet each of the above objectives. These plans in particular, and others of a similar

72-172—76——2

scope and nature. should be subject to detailed debate within the Federal Government beginning this year so that the people of this country may soon benefit from such programs, both directly through their stock ownership and indirectly through the more efficient economy that would result.

The ESOP (Employee Stock Ownership Plan), as practiced in the United States, is a valid and beneficial device for broadening the ownership of new capital through stockholdings as well as providing an alternative financing mechanism for corporations, but ESOPs are not universally beneficial nor should they be made to be.

ESOPs share certain characteristics with other employee benefit plans—profit sharing, thrift and savings, and stock purchase or bonus plans. Each: (1) Is a single firm fund without diversification which enjoys preferential tax treatment; (2) is a defined contribution plan; and (3) usually covers a wide range of employees. ESOPs differ from profit-sharing plans in that employer contributions to employee stock ownership trust (ESOT) need not be based on company profits, and distributions to ESOP employee-participants must be in stock while profit-sharing plans may be in cash. Unlike stock bonus plans, ESOPs can be used as a technique of corporate finance.

ESOPs can be advantageous to corporations in a variety of ways, most of which involve tax savings. They may also enhance employee motivation which in turn increases productivity, but this effect will vary greatly depending primarily on the size of the company, the composition of its work force, and the goods or services it provides. The companies most likely to benefit are those in labor-intensive industries, and service companies rather than manufacturing companies. The primary benefits to the employees is obtaining an ownership interest in their company without any immediate cash outlay.

Each of the three parties involved—the stockholders, the employees, and the corporation—all confront possible problems or disadvantages involved with ESOPs. The prior stockholders face the definite problem of dilution of their holdings. This could be a permanent problem unless the new funds obtained through the ESOP yield a high and continuing return on their investment.

Employees face two potential problems: (1) Their stockholdings are not diversified and, moreover, are tied to their company of employment, greatly increasing financial risk in case of company decline or failure; and (2) they may not receive any dividends or only a very insignificant amount, as has proven to be the case with companies currently using ESOPs.

For the corporation, using an ESOP as a leveraged finance mechanism may not be possible in designing a plan which by law must be exclusively for the benefit of employees. Other problems arise in: (1) Buying back the stock from employees, which may create cash flow problems or depress the market value of the stock; (2) determining the value of the stock (for closely held companies only); and (3) actually achieving an increase in employee motivation or productivity. Moreover, companies with low effective tax rates will find ESOPs of little advantage.

Comparison of ESOPs with other techniques of corporate finance shows conclusively that ESOPs do have a cost which is likely to fall on the prior shareholders. Furthermore, using ESOPs, or a conventional loan with the company contributing stock to an employee trust, yield essentially the same financial results. A comprehensive analysis of many different financing alternatives done for the committee by Steven Seeberg showed that ESOP financing did improve the debt-equity ratio, but where additional plan contributions are necessary to implement the ESOP, no ESOP technique at any P–E multiple produced acceptable increases in earnings per share. The most significant conclusion to be derived from this study is that whether or not ESOPs are the most attractive financing technique depends entirely on the specific circumstances of the corporation at a given point in time. In many cases, more traditional modes of financing would serve the company better. This indicates a more limited scope for their adoption than Kelso envisions, which in turn means their potential impact on the economy is decreased.

Macroeconomic analysis shows that widespread adoption of ESOPs would: (1) Stimulate capital formation, but that this objective could be achieved by many non-ESOP methods which also lowered the cost of capital: (2) be very likely to increase inflation, especially as greater economic growth led to conditions approaching full employment; (3) not lead to a surge in consumer demand through their increased incomes since the "second incomes" from dividends would be quite small for many years, and many workers would not be receiving them; and (4) lead to a loss of tax revenues which, though very difficult to estimate, could be very significant.

The comprehensive examination of ESOPs undertaken provided the basis for recommendations on how the law governing ESOPs should be changed, what actions should be practiced whenever feasible, and on the question of future incentives for ESOPs. These were summed up as follows:

In order to increase employees' interests in such plans and to better insure that they will definitely benefit the employees, the following provisions should be made part of the law governing ESOPs and the incentives for their adoption: (1) All stock held by the ESOT should have voting rights equal to the voting rights of other employer common stock, and for publicly held corporations, these rights should be passed through to the employees; (2) an advisory committee to the ESOP trustee should be established by vote of the employees; (3) the current limitation on annual corporate contributions to the ESOT should be removed, provided that the funds channeled through the ESOT are used for corporate expansion; (4) a ceiling of $500,000 should be imposed on the amount of stock which can be allocated to an employee's account in an ESOT; (5) ESOTs should be allowed to trade in the stock of other companies up to a certain percentage maximum. Though not recommended as part of the law governing ESOPs, the following actions should be practiced whenever feasible: (1) Annual distribution of dividends to the employees; (2) shortened vesting schedules; and (3) provision of loans to employees by the ESOT.

Further incentives for the establishment of ESOPs are not needed at this time. However, if Congress wishes to provide such incentives, they should be more specifically targeted to insure that companies which would already be attracted to ESOPs do not unnecessarily benefit from further incentives. One method meeting this criteria would be a tax credit or deduction based on the amount of additional contributions required in the year of the financing to implement the ESOP, with the credit or deduction gradually decreasing to zero over a given number of years.

INTRODUCTION

Personal Wealth: Composition and Distribution

Personal wealth in the United States in 1972 totaled $4.3 trillion while net worth, which takes into account the debt of individuals and families, totalled $3.5 trillion. This means that the average sized family would have, if the wealth were evenly distributed, almost $73,000 and a financial net worth of $59,200. Yet the startling fact is that less than one family in eight had a net worth of $59,200 in 1972. The reason is simple: wealth is highly concentrated in the United States.

This situation has led to periodic proposals for broadening the ownership of wealth. Since much of personal wealth is generated by the yield on capital, this report analyzes various plans which could achieve the goal of broadening the ownership of new capital in the United States. This is the most direct, effective and equitable means of providing an opportunity for more American citizens to share in the great wealth produced each year. The focus is on broader distribution of future wealth rather than the redistribution of presently existing wealth.[1]

Table 1 clarifies the composition and distribution of personal wealth. Although personal wealth is made up of many types of assets, real estate, corporate stock and cash are of overriding significance, accounting for nearly three-fourths of the total. Holdings of real estate and corporate stock, the two with the greatest value, represent ownership of capital.

TABLE 1.—PERSONAL WEALTH, 1972

Asset	All persons	Value (billions) held by the richest—		Share held by the richest—	
		1 percent	6 percent	1 percent	6 percent
	(1)	(2)	(3)	(4)	(5)
Real estate	$1,492.6	$225.0	$645	15.1	43.2
Corporate stock	870.9	491.7	629	56.5	72.2
Bonds	158.0	94.8	124	60.0	78.5
Cash	748.8	101.2	278	13.5	37.1
Debt instruments	77.5	40.8	475 (Debt instruments, Life insurance, Trusts, Miscellaneous)	52.7	40.5 (Debt instruments, Life insurance, Trusts, Miscellaneous)
Life insurance	143.0	10.0		7.0	
Trusts	99.4	89.4		89.9	
Miscellaneous	853.6	83.3		9.8	
Total assets	$4,344.4	$1,046.9	$2,152	24.1	49.5
Liabilities	808.5	131.0	300	16.2	37.1
Net worth	3,535.9	915.9	1,852	25.9	52.4
Number of persons (millions)	209.0	2.1	12.8		

Source: Cols. (1), (2), and (4): James D. Smith and Stephen D. Franklin, "The Distribution of Wealth Among Individuals and Families," 1975. Cols. (3) and (5): Internal Revenue Service, "Personal Wealth," 1976.

[1] Redistribution of income, rather than wealth, is already being attempted through the many income support and income transfer programs now in operation. Though such programs are necessary to remove some of the hardship of poverty and to fulfill basic needs, they are still only marginally effective. Despite them, the distribution of income has remained virtually unchanged since World War II: the top quintile of the population holds just over 40 percent of the income and the lowest quintile has 5 percent. Even these figures understate how rich the rich really are for the top quintile of families have almost 80 percent of total personal wealth. Clearly, income will not become more equally distributed in this country until the base of wealth holdings is broadened.

The concentration of wealth can be seen in columns (2)–(5) of table 1. The richest 1 percent of the population not only owns nearly one-fourth of the total assets in the United States, but the composition of their wealth holdings differs markedly from that of the general populace; real estate goes from a strong first among Americans at large to a weak second place among the richest citizens with a value less than half of their holdings of corporate stock. A report on personal wealth, recently released by the Internal Revenue Service (May 1976), conveys essentially the same picture for what the IRS terms the "top wealthholders," defined as persons with gross estates greater than $60,000. The main difference for this group, comprising the richest 6 percent of the population, is that real estate is relatively more important in their total asset holdings. Still, as shown in columns (2) and (3), corporate stock and real estate account for over two-thirds of the total asset value for those who are very rich. The most striking feature of these data is that almost one-half of the total assets in this country are owned by these top wealthholders. The composition of wealth is important in later consideration of the types of programs that will be most effective in broadening the ownership of new capital.

The most useful measure of wealth is net worth because by subtracting debts from gross assets, this concept better conveys what people truly own. Since debt, as table 1 shows, is not as highly concentrated as the ownership of assets, the concentration of wealth is even greater when measured by net worth. For example, the 5.2 percent of the population aged 20 and over in 1972 whose net worth was greater than $60,000 held 43 percent of personal wealth. The number of individuals in this group is less than half that reported in column (3) of table 1 who held approximately 50 percent of personal wealth.

Since debt is more highly concentrated among the lower and middle classes, their net worth is most revealing. Despite the fact that America is usually referred to as a prosperous, middle-class country, where 64 percent of the population have their own homes, a recent estimate indicates that 55 percent of U.S. families had less than $10,000 net worth and 12 percent had less than $1,000 net worth. It appears as though accumulating even modest capital holdings is not easy for over one-half of American families, even though 54 percent of these families have two earners or more.[2]

The issue of whether action should be taken to influence the distribution of newly generated wealth can be clarified by considering the following facts and questions. In the 10-year period prior to 1972, personal wealth more than doubled, increasing by $2.2 trillion. Though difficult to project accurately, a conservative estimate would be that personal wealth over the next 10 years will increase by $3 trillion to $4 trillion. The question is: Should the United States allow most of this wealth to accrue largely to the present top wealthholders, which

[2] The insignificance of capital holdings for lower and middle income Americans is also shown by the following statistics. Of the total income reported in the under $20,000 income tax returns filed in 1971, about 90% came from wages and salaries. Income from dividends, interest and capital gains for those in the $5,000 to $10,000, $10,000 to $15,000 and $15,000 to $20,000 categories constituted 4.7 percent, 3.6 percent and 4.6 percent respectively of total income. This contrasts sharply with the percentages for the $100,000 to $500,000, $500,000 to $1 million and $1 million-plus categories which were 46.3 percent, 79.5 percent and 86.5 percent.

has been the historical pattern, or should it begin to develop programs that will spread this newly created wealth more broadly among its citizens? For the world's most affluent capitalist nation, yet one in which so few citizens own capital to any appreciable degree, the answer should be an unqualified yes.

Broadening the Ownership of New Capital as a National Economic Goal

The Joint Economic Committee was formed in 1946 with a mandate to suggest policies to keep the Nation at, or at least moving toward, full employment. The Nation benefits in many ways when it operates at full employment, and it is imperative that we continue to provide opportunities for all individuals who desire to work.

Two other goals of the committee have been to promote purchasing power and economic growth. Both of these goals would be served by broadening the ownership of new capital. Purchasing power will be enhanced as more dollars flow as dividends to lower and middle-income households. Economic growth will be stimulated both by the increased consumption demand flowing from the augmented incomes of consumers and from a more healthy corporate financial structure as new equity issues play a more dominant role in capital formation.

In order to provide a more broadly based, democratic capitalist system, the United States should establish mechanisms which will permit workers to acquire capital as a supplement to earnings from their jobs.[3] Establishing methods other than employment to put additional purchasing power in the hands of American citizens on a broad scale is not a new goal. When Congress adopted the stock bonus plan in the 1920's, its intention was to vest the employee with capital so that he or she might have a secondary income which would continue after labor efforts ceased. The 1976 Annual Report of the Joint Economic Committee has called on Congress to once again affirm such a goal, not just for employees but for all American citizens. The Report's recommendation stated:

> To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership. Congress also should request from the Administration a quadrennial report on the ownership of wealth in this country which would assist in evaluating how successfully the base of wealth was being broadened over time.

If we aim to broaden the ownership of new capital, we must determine (1) the type of asset(s) whose ownership can be most advantageously affected, and (2) the most effective programs to influence future ownership of the chosen asset. Chapter 1 provides the facts

---

[3] There have been other expressions of support for a goal of broadening the ownership of new stock: "Profit-sharing in the form of stock distributions to workers would help to democratize the ownership of America's vast corporate wealth," Walter Reuther, president, UAW.

"We believe it is desirable to broaden stock ownership. It is highly important to do this in order to foster participation by more people in providing growth of the economy and its capacity to satisfy the everincreasing demand for jobs." Charles Walker, Assistant Secretary of the Treasury for Tax Policy, in statement to the Joint Economic Committee.

"If a country in which only a few men and women are citizens is politically unjust, the remedy is not to abolish citizenship but to make all men and women citizens. If an industrialized country in which only a few own all the capital is economically unjust, the remedy is not to abolish private capital but to make it possible for all to become owners of some of it." Winnett Boyd, president, Arthur D. Little. Canada.

and figures which underlie the choice of corporate stock as the target asset. Chapters 2 and 3 describe and assess various programs which would both increase and broaden stock ownership among individuals and stimulate the greater use of new equity issues to meet future corporate financing needs.

Four programs have been selected for special emphasis. Employee stock ownership plans (ESOPs) have been accorded a separate chapter and more detailed analysis, not because they are necessarily the favored method, but because they are of such great current interest to many individuals concerned with corporate affairs and are at the forefront of Congressional attempts to broaden such ownership. As such, they need to be thoroughly analyzed to determine their potential value not only to individual corporations and their employees, but also to the U.S. economy. To this end, the Joint Economic Committee held hearings in December 1975 on this concept and received much information through followup questions and submitted statements.

Of the three remaining programs, the Wage Earners' Investment Fund concept is most similar to ESOPs in that (1) it is in current use and at the center of debate on broadened stockownership in Western Europe and (2) it is focused solely on employees, providing them stockownership at no out-of-pocket cost. The other two programs—the "Capital Formation Plan"—and the "financed capitalist plan," are hypothetical comprehensive systems for all citizens, not just corporate employees. In the capital formation plan, the tax system is used to encourage not only the buying of stocks by individuals but also greater corporate use of equity financing and distribution of their earnings in the form of dividends. The financed capitalist plan actually changes completely the structure of corporate financing, requiring that all capital expenditures be financed from the issuance of new equity and that all earnings must be paid out as dividends to the stockholders which would be a deductible transaction. The other major difference of this plan is that no cash outlay is required by the participants who obtain a diversified stock portfolio after a nonrecourse, self-liquidating loan through a commercial bank has been repaid from the dividends paid on the stock in the portfolio.

Chapter 1. OWNERSHIP OF CORPORATE STOCK AND ITS CONTRIBUTION TO CAPITAL FORMATION

Diminishing Contribution

In the first three decades of the 20th century, stocks provided 11 to 19 percent of the funds for U.S. nonfinancial corporations. As table 2 makes clear, the contribution of stocks as a source of funds dropped dramatically over the next three decades to a range of 4 to 9 percent.

TABLE 2.—STOCKS AND BONDS AS SOURCES OF FUNDS FOR U.S. NONFINANCIAL CORPORATIONS

	Percentage contribution									
	1901–12	1913–22	1923–29	1930–33	1934–39	1490–45	1946–49	1950–58	1959–61	1962–64
Stocks	14	11.2	19.4	---------	9.0	4.6	6.6	6.4	4.0	0.9
Bonds	25	7.2	7.1	---------	−11.4	−6.1	11.7	10.6	9.3	9.0

Source: "Investment Banking and the New Issues Market," Irwin Friend.

During the last 15 years, their role has been insignificant: during the 1960's new equity issues accounted on the average for only 7 percent of the total financing sources of nonfinancial companies, while the average for the 1970's to date has been 5.9 percent. Last year, new equity offerings for nonfinancial companies totaled only 7.1 billion out of a total level of financing for these companies of $147.3 billion, with just 568 companies using new stock issues to help raise capital. At the same time, the total market value of stocks traded on all registered exchanges in 1975 was $157.3 billion which indicates that less than 5 percent of stock transactions were for directly fostering new capital formation. Clearly the stock market no longer plays a significant role, as it once did, in financing the growth of the economy.

The rapid growth of bond financing has accompanied this decline of stocks as a significant source of funds for corporate expansion through new capital formation. Apart from the first decade of this century, bonds were a minor partner to stocks as a source of external funds until after World War II. Beginning immediately after the war, and continuing for the next two decades, as seen in table 2, their share was usually approximately double that of stocks.

In recent years, there has been a much more dramatic shift towards debt. In the first half of the 1960's, new equity issues exceeded additions to debt by $10 billion while during the past 10 years, the position has been more than reversed with debt additions exceeding new equity by $190 billion. In the 1964–74 decade, the overall debt-equity ratio for all U.S. manufacturing corporations rose from 25 to 43 percent. This trend has become so pronounced that many argue that business has built far too much debt into its capital structure. The more dire warnings revolve around the theme that unless equity financing increases

72–172—76——3

relative to debt, the rate of economic growth will slow down and possibly halt, or epidemic business failures will occur.

Without subscribing to the overstated calamity scenarios, a case can be made that stocks should once again become a realistic and significant source of business capital. Although recent projections indicate that new stock issues will attain a rather prominent role in 1976, perhaps reaching the record $13 billion level of 1972, it is much too early to conclude that a significant turning point has been reached. Even with this potential record surge of new stock issues, many companies may still be precluded from the market place because of their small size or poor condition. The structural tiering of the corporate sector, which puts such companies into low-rated categories, will continue to be a problem for quite some time and could prove to be a potential drag on the economy.

Why are corporations reluctant to issue new securities? One major reason is the deductibility of interest costs which makes debt financing more attractive since there is no equivalent corporate deduction for dividends paid although they, like interest, are a cost of capital. Present laws also tax sales of appreciated stock at lower rates than dividend income, thereby encouraging the retention and reinvestment of corporate earnings. Internal financing, which over the past two decades has accounted for between 60 to 70 percent of the capital funds raised by nonfinancial corporation, also avoids SEC disclosure requirements and the resulting external assessment of a company's past performance and future prospects. Many question whether such substantial reliance on internal financing is consistent with optimal allocation of economic resources since, the argument runs, such financing, unlike equity financing, does not have to continually meet the test of the capital market. This "captive capital" is not allocated by investors with the full unlimited range of alternatives in mind. (See f.n. 4 in chapter 2.)

Ownership by Individuals

A recent NYSE report highlighted some interesting trends in stockownership for the first half of the 1970's. Perhaps the most important was the 18-percent decline in the number of individual shareholders in the United States from 30.8 million in 1970 to 25.2 million in mid-1975, the first decline since the initial NYSE study in 1952. A major reason for this drop can be discerned from another major finding of the study: the median age of shareowners had increased by 5 years, from 48 to 53. This suggests that young adults, in their twenties and thirties, are not buying shares in any meaningful numbers so that the basic core of shareowners is the same as in 1970. This study also found that the median shareowner has an annual household income of $19,000 and held a stock portfolio valued at $10,050. These findings are a good first step in determining who owns the outstanding stock in this country and how ownership trends are changing, but more detailed data are necessary in order to obtain a clear understanding of changing stockownership patterns.[1]

[1] For instance, the following information would be quite useful: how many adults in their twenties and thirties buy stock each year and who are the principal purchasers of new stock issues.

Since a major portion of this report focuses on ESOPs, it is necessary to understand how individual stockholdings are distributed by employment status. Surprisingly, employed persons in 1971 accounted for less than half of the market value of stock held by individuals. Of the total value of stockholdings by the employed, managers and professionals accounted for 60 percent. This means that all other workers, including clerical, sales, farmers, and general blue-collar occupations, held only 19 percent of the market value of individuals' stockholdings. This is a small percentage given their numerical strength in the economy which in 1971 was 59.4 million or 76 percent of the employed labor force.

Since for many years stock has been by far the largest of the financial assets held by families, it is important to examine the distribution of stockholdings among broad income groups. Despite the very large number of stockholders, most of the outstanding stock held by individuals, with an estimated value of $871 billion in 1972, was owned by a very small number of extremely wealthy individuals. For example, exactly two-thirds of the $871 billion was owned by persons with a net worth greater than $60,000 who, as noted in the introduction, constituted 5.2 percent of the population age 20 and over.[2] Even this, however, underestimates the degree of concentration, for within this select group the ownership of stock is highly concentrated. Almost exactly one-half of the total value of outstanding stock, $429 billion, was owned by the richest 1.04 million individuals in 1972 who comprised just 0.5 percent of the population or 0.8 percent of those over 20 years old.[3] The 1976 IRS report, "Personal Wealth," showed that the concentration exists even within the wealthy group for among the top wealthholders (gross estate exceeds $60,000) almost one-half of the corporate stock was held by those with a net worth of $500,000 or more who constitute only 4 percent of this group. On the other hand, the bottom 25 percent of this group, those with net worth less than $60,000, owned only 3 percent of the stock.

This tremendous degree of concentration should be of concern for the following reasons. First, it essentially means that virtually all lower and even middle income individuals have not been able to obtain a significant share in America's corporations which provide so much of the wealth added each year. In 1971, for example, the 94-percent of families and individuals with an income less than $25,000 held only 30 percent of the aggregate market value of stock that year and received only 33 percent of the dividend income. Those individuals and family units with an income less than $10,000, who were more than one-half the population, held less than 10 percent of the market value of stock and received only 11 percent of the dividend income.

Second, these concentrated holdings contribute to the cumulative and self-reinforcing nature of the concentration of wealth and income. The high concentration of stock ownership leads to a situation where the income from profits is so highly concentrated that its recipients are in the highest income brackets. Since these people are the only ones

---

[2] This fact, it should be noted, refutes the statement continually made by Louis Kelso that 5 percent of consumer units own virtually all the personally owned corporate stock.

[3] A study based on 1969 data showed that the top 1 percent of the shareowners (0.2 percent of the total adult population) owned nearly a third of all stock.

able to save significant amounts, they make the large investments, thereby increasing their stock ownership. Thus, the circle is established.

The third reason has to do with the special significance of the distribution of corporate stock as it relates to distribution of economic power. A firm's total assets often may be effectively controlled by the owners of a minority of its stock, thus magnifying the power over assets that stockownership can convey. Thus, it can be inferred that for all practical purposes, the 5.2 percent of the adult population who own two-thirds of the value of all privately held corporate stock have a large measure of effective control over virtually all corporate assets.

Rise of Institutional Investors

The major trend in the ownership of stock since World War II has been the rising role of institutional holdings. As table 3 shows, prior to that time, individuals owned virtually all stock through direct holdings.

TABLE 3.—MARKET VALUE OF U.S. CORPORATE STOCK BY CLASS OF INVESTOR: TOTAL AMOUNTS AND PERCENT DISTRIBUTIONS, SELECTED YEAR-ENDS 1900–75 [1]

Class of investor	1900	1929	1945	1958	1963	1975
Total amount of stock per year (billions)	$11.1	$144.4	$122.0	$394.8	$603.5	$802.8
Percent distribution stock: [2]						
Noninsured pension funds	0	.1	.2	2.7	4.6	11.0
Life insurance companies	.6	.2	9.8	1.0	1.3	3.5
State and local government trust funds	0	0	—	.1	.2	3.2
Investment companies	0	1.5	2.4	4.6	5.4	5.6
Other institutions and foreigners	2.9	2.4	5.0	4.6	5.0	12.0
Individuals [3]	96.6	95.8	91.5	86.9	83.4	64.7

[1] Excludes holdings by nonfinancial corporations. Includes foreign issues and securities offered by financial intermediaries.
[2] Dash (—) + zero or too small to be recorded.
[3] Includes trust funds for 1900–63. 1975 includes personal trusts.

Source: For 1900–63, Irwin Friend, "Investment Banking and the New Issues Market." For 1975, calculated from SEC data.

Individual investors were the largest net buyers of stock until the mid-1950's, at which time noninsured pension funds and mutual funds became the largest net buyers with pension funds by far the most important. The facts of this trend belie the conventional wisdom concerning how significant individual ownership of corporate stock has become in the past two decades. In fact, for each of the last 18 years, individuals have been net sellers of stock, averaging a yearly decline in their equity holdings of $5 billion. Consequently, their share of the market value of outstanding stock decreased from 87 percent to 65 percent (year-end 1975) in this period. Institutions in 1975 held 29 percent, while foreign holdings were 6 percent.

Since pension funds have become the most significant new factor in stockholdings and net purchases of new equities, it would be useful to examine some of the key facts concerning this form of beneficial stockownership for the worker. At the end of 1975, private pension plans had $215 billion in assets. Approximately two-thirds of these assets consisted of the stock of publicly owned American companies. Since the total value of the stock of all publicly held companies was $838 billion (in midyear 1975) pension funds held approximately

20 percent of the market value of outstanding stock. This indicates a dramatic increase in their importance, for in just over a decade, their share had increased fourfold, from just under 5 percent to 20 percent. This is largely due to the fact that each year, pension funds must find investment outlets for the net increase in their reserves, which in the 1970's has ranged between $12 to $20 billion. This provides the potential for a large shift of capital assets to the pension funds.

It has been estimated that about 15 million governmental employees, 30 million nongovernmental employees and some 2 to 3 million self-employed people were covered by pension plans in 1973. It is expected that their growth will continue over the next decade, so that by 1985 nearly two-thirds of the total labor force of 95 million will be covered. More significantly, these employees may own up to 50 percent of the equity capital of American business through this means, excluding personal ownership of stock by individual workers.

Given this type of asset strength and widespread coverage, pension funds will be able to provide a relatively substantial income to at least one-half and up to two-thirds of all Americans reaching retirement age. One estimate is that about two-fifth of retirees can expect a household income of some 60 percent or more of the main income earners' preretirement income, with the private pension accounting for half or more of the total.[4]

In testimony to the Joint Economic Committee, Charles Walker of the Treasury Department indicated that private pension fund reserves are already a significant portion of total wealth, comprising approximately 8.3 percent of the total financial assets of all families. This percentage, moreover, is bound to increase since the current annual flow of funds into private pension reserves comprises about 13.6 percent of the net acquisition of financial assets by families.

Up to this point, the growth trend of pension funds in the U.S. economy has been seen as healthy and positive. However, the economic implications of the increasing acquisition of corporate stock by pension funds have not yet been examined. Actually, the broadening of the ownership of new capital through this indirect means for workers may not be an entirely positive development.

Some are concerned that with this trend, capital market decisions are effectively being transferred to asset managers from "entrepreneurs." Theoretically, since asset managers must follow the "prudent-man" rule, they will not be as able to take risks in investing for the future and thus may diminish the amount of capital for change and growth, particularly for the new small and growing business.

This follows from the fact that institutions tend to buy and sell large blocks of stock, concentrating their activity on a relatively small number of large issues. Also, since the asset managers have access to the same information and closely follow each others' assessments and actions, they are often on the same side of the market. This is beneficial in that it leads to more prompt and accurate adjustment to information, but it could also lead to greater price volatility, which

---

[4] This estimate and most of the prior facts and projections concerning pension funds are based on Peter Drucker, "Pension Fund Socialism," Public Interest, Winter 1976.

increases the risk of investing in stock and hence the cost of equity capital. Institutions can also penalize new ventures by depressing the prices of their issues through diverting funds that would otherwise have been invested in small and risky issues. Thus, we may be in the process of evolving a capital market less well equipped to supply entrepreneurial capital needs.

Relying solely on pension funds to broaden the ownership of new capital also means that what is being paid into the pension account of an individual, although comprising "savings" for that person, is really not all devoted to capital formation but partly to transfer payments to retired workers. As noted above, however, corporate pension funds have contributed to capital formation due to their $12 to $20 billion net intake. In fact, for the last decade, only the retained earnings of industry have been a larger source of funds for capital formation. By the late 1980s, however, it is likely that pension funds will have become pure transfer mechanisms, perhaps even dissaving because of the demographic trends which will lead to more benefit payments and less receipts. This will certainly be a fundamental problem of the increasingly predominant role of pension funds in our society.

Chapter 2. ALTERNATIVE METHODS FOR BROADENING THE OWNERSHIP OF NEW CAPITAL

Broadening the ownership of new capital can be accomplished in a number of ways. This chapter examines the major features and relative merit of several major alternatives, most of which have not been explicitly considered by the Congress before. Plans which aim to increase stock ownership among employees of corporations are considered, as well as more broadly based methods which aim to increase stock ownership primarily among lower and middle-income people.

METHODS AIMED AT INCREASED EMPLOYEE OWNERSHIP

Incentives to the Employees

Employee ownership of stock can be increased by directing the incentives at the employee rather than at the firm as under ESOPs. The employee is thereby given a choice as to whether he or she wants to participate in the ownership of the firm. The various methods used to accomplish this primarily involve strengthening incentives already in operation.

One alternative would be to liberalize the tax benefits for stock purchase plans, thus providing employees further inducement to place their savings in the employers' stock. At present, participants in broad-based plans are permitted to purchase employee stock at up to a 15-percent discount without immediate taxation. These plans have not been widely used because of the ceiling on the discount, the fact that the employer does not obtain a tax deduction for the discount and that the employee realizes ordinary income, rather than capital gain, from the discount upon sale of the stock. Legislation eliminating these disadvantages would encourage the wider use of such plans.

An alternative, suggested in the JEC's ESOP hearings by Robert Flint of A.T. & T., is closely related to the basic stock purchase plan. It involves using the investment-tax-credit ESOP (ITC–ESOP) available under the Tax Reform Act of 1975 in a different manner (see appendix A for the Act's provisions). Instead of receiving the allocation of stock as a mandatory "gift", employees could be given the option of receiving shares as currently provided or paying for shares under a tax-qualified employee stock purchase plan at a rate reduced by the amount saved through the ITC–ESOP. Participation would be based on some percentage of the employee's salary, but with a limit on the number of shares which each could acquire. Shortening the presently required 7-year holding period would be allowed since the employee would be contributing his or her own savings.

The statement of Mr. Flint maintained that the most important advantage of this modification vis-a-vis the ITC–ESOP now in effect, which is an outright gift by the Government to the corporation, is a multiplier effect, by which each dollar of lost Government rev-

enue would generate several dollars of new equity investment from employee savings. For the employees, this modification provides some stock for the employee who cannot afford an out-of-pocket contribution, while it encourages the employee who can save to direct the savings dollars toward needed equity investment.

Another alternative form of employee stock purchase plan involves the provision of an interest-free loan by a company to its employees for the purchase of its stock. The employees could purchase company stock up to a value of 50 percent of their annual earnings, repaying the company over a period of 5 years. From the day of purchase, the employee would receive complete dividends on the amount of stock purchased even though in effect the stock has not been purchased in full.

An incentive may also be provided to bring employee stock ownership into the collective bargaining process, and thus heighten the interest of organized labor. Such an incentive is provided in the Javits-Humphrey bill outlined in Appendix C.

Wage Earners' Investment Funds—A West European Idea

In the past two decades many European countries have begun to consider giving labor a share of the capital gains accruing to stockholders as well as the codetermination rights inherent in stock ownership. To help accomplish these two objectives, six countries almost simultaneously developed alternative types of wage earners' investment funds (WEIFs). Two countries, West Germany and France have had a WEIF in effect for many years.

This concept has sprung up across Western Europe in the last two decades because of labor's discontent with its share of the fruits of economic progress. Continued inflation has made labor realize that real-wage rate increases are limited by technological progress which lies outside the collective bargain process. Nonindexed personal income tax systems mean that money-wage-rate increases increase the tax bite and reduce the share of real wages remaining after tax. As a result, labor unions in Europe have been looking for new dimensions of collective bargaining in order to obtain what they see as their proper share of such tangible benefits as capital gains and codetermination rights. Thus, in most instances, the unions and the labor parties have been the supporters, if not the initiators of the movement for establishing WEIFs. This is completely contrary to the situation in the United States, where national labor unions and the AFL–CIO have not only never suggested initiatives along this line but for the most part have steadfastly refused to evaluate new ideas such as ESOPs. (See p. 38 for their objections.)

Briefly, the general structure of a WEIF is as follows. Employers would contribute, preferably in the form of stock, some fraction of their wage bill or profits to a fund which belongs to the employees. The fund would be allowed to sell this stock at any time and buy other stock. Fund certificates to the employees could either be shared equally or be distributed in proportion to the employee's salary. These certificates would become redeemable in cash a specified number of years after their issue. The employees would receive an amount that includes all capital gains and dividends made on their allotted shares during the lifetime of the certificate.

A critical consideration is how centralized or decentralized the fund should be. Extreme centralization would involve a fund that encompasses the entire economy. All firms would contribute and the fund would own a share of all of them. Extreme decentralization would mean that the fund would be limited to the shares of one firm and could not sell its shares of that firm or buy shares of different firms. Between these two extremes lies the possibility of a number of funds which may or may not compete against each other. With competing funds the employee would be free to choose among them. Each fund could own shares of any firm in any industry or region (thus this situation is closest to the centralized case). A system of noncompeting funds would confine the fund to a particular industry or a particular geographical region. The employee would not have freedom of choice since he or she automatically would belong to one fund according to industry or residence. Such an industrial or regional fund presumably would be allowed to buy only shares of firms within that industry or region.

The degree of centralization characterizing the fund bears directly on its freedom to allocate capital among industries and its value in enhancing labor productivity, both of which will help determine the country's rate of economic expansion.

Since the fund under extreme decentralization may not sell shares of its own firm and buy into others, it cannot spread risks among firms, industries and geographical regions. This lack of diversification leaves little scope for the fund to maximize its rate of return. This type of fund, however, could induce the individual employee to raise his or her labor productivity since the value of the employees' shares could benefit from such a rise. But let us keep in mind, as we look next at the opposite case, that this productivity increase is of the simple "plant floor level" nature.

Under the more centralized cases (either one central fund or a system of competing funds), there is more scope for maximizing the rate of return as a fund can spread its risks among firms, industries, and regions. In fact, competing funds would be under powerful competitive pressure to seek maximum returns. Such funds would do nothing to stimulate the type of "plant-floor productivity" mentioned above. However, they would probably contribute to labor productivity in a more subtle but also potentially more powerful way. It simply boils down to the broad process by which a Nation achieves healthy productivity growth rates each year.

Basically, labor productivity has been steadily raised by new technology which requires more physical capital per employee as well as more human capital embodied in each worker. This must be accomplished across the entire economy and over the long run, since it requires a continually changing allocation of capital and labor to match the evolution of technology. Under capitalism, free capital and labor markets lead to such allocation. Thus, a more centralized WEIF is most beneficial in the sense that restrictions impede the mobility of capital among industries. Such mobility is totally eliminated under a single firm fund. In addition, since contributions to such a fund must remain invested in the firm, workers might be deterred from leaving the firm for fear of losing their share. Thus, capital as well as labor

would be tied more closely to the firm, reducing the mobility of both to move to uses yielding a higher return.

Hindering the free flow of capital is one way that a WEIF could interfere with the complex mechanism known as the capital market. There are two other ways it could interfere. A WEIF could be less clearly motivated than a regular stockholders' fund to insist on profit maximization, because of the conflict under the WEIF between the wage earner as owner and as employee. The resulting malallocation of resources might keep less capital-intensive, less rapidly growing and less well managed firms alive at the expense of more capital-intensive, more rapidly growing and better managed firms.

The second way in which a WEIF could interfere with the capital market is by narrowing the opportunities for internal financing, for it induces firms to substitute less risky for more risky projects. This could ultimately decelerate technological progress. At the same time, it can be argued that substituting the issuance of stock for internal financing is a welcome development as it would strengthen capital market discipline by submitting funds previously withheld to the capital market test. This in turn would increase the free flow of capital among firms, industries and regions.

Professor Hans Brems, who undertook the analysis leading to the above conclusions on the possible capital market effects of a WEIF, also examined the possible macroeconomic effects. He stated his conclusions quite succinctly:

> First, a wage earners' investment fund would reduce the national disposable-income fraction of national output. Second, it would redistribute disposable income in labor's favor. Third, the investment wage would have a weaker redistributive effect than would profit sharing. The reason is that the former could be shifted to the price of goods while the latter could not. Fourth, the fund might raise the propensity to save national output. An investment wage with its weaker redistributive effect would be more likely to do so than would profit sharing.[1]

The experience of West Germany will help us better understand how a specific WEIF would operate. This country was chosen since its economy is similar in many ways to that of the United States, it is the source of the most comprehensive thinking on alternative forms of WEIFs, and it has the longest and most broad-based experience with such a plan.

The German plan, enacted in 1961 and revised twice, provides tax relief for wage payments voluntarily invested by workers. The contributions may be placed in stocks or bonds issued by the employing firm, in blocked accounts in saving banks or commercial banks where they must remain for 5 years, or they may be used to finance own-home construction. These contributions, which employers may exempt from the German wages tax, are limited to 624 Deutsche Marks ($242) per worker per year. The German worker must pay tax and social insurance contributions on these investments, but the Government grants a tax-free bonus for 30 percent of the amount invested (40 percent for workers with more than two children). Low-income persons receive an additional bonus of 40 percent of the tax-free amount under the general bonus. Thus, the maximum would be a tax-free contribution of 56 percent (40 percent plus 16 percent) of the amount invested. These funds have had significant influence as over two-thirds of German

---

[1] Hans Brems, "A Wage Earners' Investment Fund," Swedish Industrial Publications, 1975, p. 44.

households participate in these measures to encourage capital accumulation.

In January 1974, the German coalition cabinet put forth a proposal closely allied to the one above. It provided that a certain percentage of profits, based on a progressive scale up to 10 percent, would be channeled through a clearing agency into various funds to be run by banks and other financial institutions. All wage earners with incomes under a certain level could choose a particular fund and buy shares in it for 10 percent of their value. The fund certificate they received, specifying their share in the capital thus accumulated, could not be sold for a period of 7 years but would be freely negotiable thereafter.

A recent Danish scheme is the most dramatic one ever proposed in that it called for a central wage earners' fund. All employees, public and private, would contribute a portion of their earnings to the fund, rising from 0.5 percent to 5 percent over 9 years. Approximately two-thirds of the contribution would remain as share capital in the company of origin, while one-third could be freely invested. All workers would receive equal shares in the fund which could be cashed after 7 years.

Eight differences between the Western European WEIFs and the American ESOPs have been observed in Professor Brems' thorough research comparing the two types of systems.

The first difference is that ESOPs add a third purpose to the two Western European schemes, namely allowing a firm to borrow for its contribution on favorable terms including tax deductibility and a tax credit. As opposed to this instantly created fund set up by borrowed cash, WEIFs rely on no outside borrowing and thus employer stock contributions must slowly build up the fund.

Second, an ESOP may not meet the European objective of giving labor a share of the codetermination rights since the law (other than that under the Tax Reform Act ITC–ESOP provisions) does not require the firm to issue voting stock to an ESOT.

Third, ESOPs are usually voluntarily set up on the employers' initiative, with no major stimulus from the employees or labor unions, while Western European schemes, also voluntary, rely on such initiative.

Fourth, an ESOP is the extreme decentralization case of a WEIF, whereas a Western European fund is a suprafirm fund, perhaps confined to a single industry of geographical region.

Fifth, an ESOP is not usually free in its early years to diversify its portfolio, while a WEIF is usually free to do so.

Sixth, the company's contribution to an ESOP may be neither an investment wage or profit sharing since under the ITC–ESOP, the employees benefit solely at the expense of the government rather than the firm.

Seventh, an ESOP freezes only the original contribution to the fund while WEIF's usually freeze in addition, all capital gains and dividends made on that contribution during the lifetime of the fund certificate.

Eighth, redemption under most ESOPs is permitted at termination of employment or at retirement, while under WEIFs it is after a specified number of years.[2]

---

[2] Hans Brems, "Wage Earners' Investment Funds—Alternative Forms and Their Economic Effects," statement for Joint Economic Committee hearing on December 11, 1975.

Methods Aimed at Increased Ownership by the General Population

The argument has been raised that if a tax incentive is offered for broadening the base of stockownership, it should not be for the exclusive benefit of employees of participating firms, but should be available to other adults in the population, including those temporarily unemployed, self-employed, or employed by nonprofit institutions, Government, and the military.

The Administration's BSOP Proposal

In the January 1976 State of the Union message, the President proposed the broadened stock ownership plan (BSOP), which provides that contributions to a BSOP, which could be established by individuals or by employers, would be deductible from taxable income up to a maximum amount. The funds in a BSOP would have to be invested in common stocks, perhaps in the form of an interest in a mutual fund, and would have to remain invested for at least 7 years. The income earned by the BSOP would be taxed only when withdrawn from the plan. Critics have pointed out that this proposal would benefit primarily people in the upper income brackets and would lock in the investment for too many years.

Countercyclical Tax Credit for Purchasing Stock

A second alternative would be to institute a tax credit for stock purchases rather than a tax deduction, since a credit would provide middle-income households the same absolute dollar incentive to become capital owners as more affluent families and individuals. Such a credit also could help alleviate a capital shortage by being activated only during periods of tight money when an incentive to save and invest is needed. For example, each person could be allowed his or her own 10-percent investment tax credit (as now given to corporations) on the first $1,000 of common stock purchases in any period when long-term interest rates are rising and when the Dow Jones industrial average (DJIA) has declined by 10 percent or more from its previous high. This would be equivalent to at least a 20-percent discount from the DJIA's preceding high. Tax incentives are especially warranted under these conditions since more savings would be socially desirable and there is a risk that stock prices would continue to decline and remain depressed for a prolonged period of time. From a fiscal perspective, the actual receipt of the tax credit should be postponed until after interest rates have peaked and the economy is in need of greater fiscal stimulus. The credit would then help to stabilize not only the stock market but the economy as well.

This line of argument holds that if tax incentives are available to fuel speculation at or near market peaks, they would help to increase market instability and also help to dissipate savings and discourage subsequent purchases when stocks are a better value. The goal is not more speculation but a greater number of satisfied stockholders who can sell their securities after a reasonable waiting period at a higher price than they paid for them.

Capital Formation Plan

Many elements of alternatives discussed previously in this chapter are combined into an interesting comprehensive package originally

developed by the Sabre Foundation. The two objectives of their capital formation plan are:

(1) To encourage corporate capital formation through increased equity financing as opposed to debt and internal financing, and (2) to make the purchase of such equity more attractive to low- and middle-income buyers, thus broadening the base of equity ownership and increasing capital formation.

Under this plan, a network of capital formation funds (CFFs) would be established across the country as a device to accumulate the savings of investors and use them to acquire a diversified portfolio of equity shares in corporations. CFFs might consist of funds created by savings institutions; labor unions; fraternal, religious, or trade associations; community corporations; employee pension, retirement, or profit-sharing trusts; or affiliates of an existing mutual fund. In each case, the CFF would be managed by either a profit or nonprofit private investment management organization. To protect investors against mismanagement of the CFF, provisions of the Securities Investment Protection Act of 1970 could be extended.

Eligible investors would be persons with adjusted gross incomes below $20,000 in the preceding tax year. Each would have the choice of taking a deduction, or a tax credit of 10 percent, of the amount invested in CFF shares up to $3,000. An investor could borrow against his equity as with an ordinary mutual fund.

In order to make these funds successful in providing broadened ownership of stock, corporations would be encouraged to engage in greater equity financing. Numerous methods could be devised, but one that is straightforward and simply provides for a new emphasis within the present tax system, is a split-rate corporate income tax, consisting of a base rate plus a surtax on undistributed profits.[3]

This type of split-rate system, which in essence effects integration at the corporate level, has been used for many years in Germany (since 1953), Japan (since 1961), and Austria. Each of these countries decided to apply a higher statutory rate of tax to undistributed income than to distributed income to give an incentive to equity financing. In Germany, the rate is 51 percent on undistributed earnings and 15 percent on applied, while in Japan the rates are 40 percent and 30 percent respectively.

The following type of corporate income tax schedule could be established for the United States:

0 percent of the first $25,000 of corporate earnings, whether distributed or retained.

30 percent on the next $25,000 of corporate earnings, whether distributed or retained.

20 percent on all earnings in excess of $50,000 that are distributed, and

50 percent on all earnings in excess of $50,000 that are retained.

[3] The other method used to effect integration, thereby mitigating the incidence of economic double taxation, is to provide relief at the shareholder level through an imputation credit mechanism. Under this system, the corporate income tax paid or accrued by the corporation with respect to the distributed profits is partly credited against shareholders' personal income tax. Among the countries using this system are Canada, France, the United Kingdom, Turkey, and Belgium. In contrast to the split-rate structure which provides relief directly at the corporate level and thus benefits all shareholders, this system ordinarily provides relief only to resident shareholders. This, in fact, was the primary benefit of the system to France and Canada which were concerned about the large concentration of U.S. ownership of business facilities within their borders.

That there would be a great tax incentive for firms to distribute more of their earnings can be seen in the following table.[4]

TABLE 4.—EFFECT OF NEW TAX SCHEDULE TO ENCOURAGE THE DISTRIBUTION OF EARNINGS

Corporate earnings (1)	Present tax (2)	New tax schedule, 100 percent distributed (3)	New tax schedule, 100 percent retained (4)
$100,000	$34,500	$17,500	$32,500
$1,000,000	466,500	197,500	482,500
$10,000,000	4,786,500	1,997,500	4,982,500

In order to make sure that much of the financing occurred through new equity shares rather than new debt, the deduction allowed for interest on new long-term debt would be decreased by 40 percentage points a year for 5 years, so that all interest after that date would be 50-percent deductible.

The next step would be to encourage corporations to sell their new equity issues to CFFs. This could be accomplished by making the dividends payable on shares sold to a CFF fully deductible by the issuing corporation for the first 10 years following the sale of the issue. Since this provision would make the raising of new equity less costly when shares are issued to CFFs, the new stock should sell at lower prices. The beneficiaries of this saving would be the lower and middle income CFF investors who have also benefited from the individual tax deduction or credit applicable to their investment.

The CFF could only sell such dividend-deductible shares during the 10-year period to another CFF or to the issuing corporation in a redemption. This would prevent the CFF from acting as a middleman for speculation in dividend-deductible stock. This dividend deductibility feature implies that if all corporate stock came to be owned by CFFs, even the low levels of tax liability shown in column (3) of table 4 would be avoided.

The revenue losses to the Treasury stemming from the tax free investments by individuals and the corporate deductibility of dividends on shares held by CFFs could prove to be large in early years. However, these would be offset in part by the investors' increased ordinary income taxes when a dividend is received or the stock is sold and also by the reduction in the amount of interest deductions reported by companies. The benefits over the long run are great both in terms of increased revenue from a greater number of people with higher incomes and also in stability for a society with less disparity between rich and poor.

---

[4] The economic argument for discouraging the use of retained earnings for corporate financing is that this will help to eliminate or reduce disequilibrium in the real capital markets by making more of the country's total earnings available for allocation to the highest bidder. If corporations, for example, were forced to pay out all of their depreciation allowances and earnings to stockholders, these funds could flow back into the real capital markets and be allocated to the areas with the highest rates of return.

Abolishing the corporate income tax in conjunction with a requirement that all earnings and depreciation allowances could be distributed to the stockholders, would be the most direct way of accomplishing the above. Restructuring the real capital markets in this way would reduce the amount and length of disequilibrium in these markets. This would lead to fewer and smaller capitalized fortunes. Of course, such measures should never be considered apart from a plan which will accomplish the broadened ownership of new capital.

This plan offers a realistic method of expanding America's productive wealth without requiring radical departures in present tax laws. Basically, the structure of the American economy would remain intact while new opportunities are opened up for low and middle income citizens to acquire an ownership in it.

Financed Capitalist Plan

This plan goes far beyond any of the other plans. The whole structure of corporate financing is completely changed, as is the ownership of all newly created wealth arising from the corporate sector. It was developed by Louis Kelso, who bases it on what he has termed his "two-factor theory." This theory posits that the role of capital and its ownership must be more explicitly accounted for and influenced by economic policy. Capital, it is claimed, produces most of the wealth in the United States and its role is increasing as every advance in technology diminishes the relative significance of labor input and increases the proportion of output attributable to the nonhuman factor—capital.[5] Hence, his proposal to develop more capital owners.

The basic features of the financed capitalist plan, as delineated in Kelso's writings, will be highlighted. Evaluation and recommended modifications will follow.

Under this plan, corporations must finance all capital expenditures by issuance of common stock make available to the financed capitalist plan. They must also pay out all of their earnings as dividends to stockholders, except for reserves needed to keep the business operating. Either such dividends will be tax deductible for participating corporations or the corporate income tax will be eliminated.

Households selected to participate in the plan could purchase a given amount of stock of the participating corporations. Actually, the "purchase" is financed through a commercial bank loan made on a nonrecourse self-liquidating basis which means the borrower has no personal liability to repay the loan and the loan is to be repaid from dividends on the stock involved. The loans are guaranteed by a Government agency called the Capital Diffusion Insurance Corp. They may also be rediscounted by the Federal Reserve Banks which would allow interest rates on such loans to be 2½ to 3 percent per year.

Each participating household receives a diversified stock portfolio of their choosing. This stock is held in escrow by the bank until the loan is fully repaid, which Kelso estimates will take an average of 7 years. At the end of this time, the stock is fully and directly owned by the household.

If this plan were fully implemented, Kelso in effect claims that a "economic utopia" would reign as it would accomplish the following specific objectives: "restoration and acceleration of economic growth to unprecedented levels," "create legitimate (not boondoggle) full employment for two or three decades," "lay the foundation for arresting inflation and initiating the hardening of our money," "achieve these

[5] Focusing so exclusively on capital, Kelso falls prey to the very charges he levels against Keynesian economists—that they only focus on one factor of production and therefore have an incomplete theory. What Kelso ignores is the fundamental fact that new machines are the product of human minds, the labor input. Indeed, considering the broader issue of what contributes to economic growth, economists have concluded that such factors as education and advances in knowledge have been much more influential than physical capital formation, the two combined contributing 2.7 times as much.

steps only through self-liquidating expenditures rather than welfare and tax cuts," "build market power into the workers," "finance these objectvies through the discount technique," and "permit the lowering of the interest rate on these selected basic types of self-liquidating new capital formation to 3 percent or less."

It should be made clear that these objectives would not be achieved because the full financed capitalist plan is not feasible as it stands, primarily because of its scope rather than its substance.

Perhaps the principal macroeconomic impact to examine is the plan's effect on inflation. Kelso has categorically stated that not only would there be no inflationary pressures resulting but that "the overall effect of the sustained new economic policy must inevitably be deflationary." His reasoning is that whatever bank credit is generated is used to finance self-liquidating newly formed capital which will "pay off" the loan in a few years and then, after the credit is totally reversed, continue indefinitely to produce goods and services. He projects that the end result of this "monetization of self-liquidating newly formed capital," coupled with a reduction of what he terms the present monetization of welfare, would be "no net increase in the money supply."

Professor Brems, in examining this line of argument for the committee's hearings on ESOP's, pointed out that this type of idea was advocated in the early 19th century under the term "the banking principle," which held that self-liquidating productive bank credit can never be inflationary. It was later shown that the inflationary impact depends on whether or not the economy is at full employment. If substantial unemployment prevails, then the lower rate of interest resulting from the rediscounting of ESOP loans will enable newly attracted borrowers to put to work factors of production which are unused. Since no other output will be curtailed, there will be a net increase in output to match the additional income generated through utilizing these inputs and hence prices will not rise. The only question is how low the interest rate must go, for when substantial unemployment prevails, investment demand is very interest inelastic. It is basically market prospects that are lacking, not capital. Therefore, ESOPs to finance corporate expansion will not be heavily used in such circumstances.

If, on the other hand, the economy is at full employment, then lowering the interest rate will lead to additional demands for inputs already being used which will cause input prices to rise. Since old output will be replaced by new output, there will be no net increase in output to match the extra income and hence output prices will rise. There remains the fundamental point that, even though vast amounts of new capital may be financed through the rediscounting of the loan paper with the Federal Reserve, there is no reason to generate such capital if additional workers do not exist. That Kelso recognizes this point is shown in a recent statement: "When the point of full employment is achieved, then the rate of economic growth cannot be accelerated, and no attempt should be made to do so." The problem is that this recognition does not seem to square with his claims that the U.S. economy can grow for the next 25 years at rates 200 percent to 300 percent higher than in the past without any inflationary pressures. Certainly it is very difficult to subscribe to the idea that the path to full

employment would take 25 years, especially if historical rates of economic growth were doubled or tripled. Kelso's macroeconomic reasoning concerning the interactions between economic growth, inflation, and full employment can be summarized as internally inconsistent.

The major substantive criticism involves the provision for rediscounting by the Federal Reserve. Rediscounting the amount of note paper involved in this plan could play havoc with economic stabilization, since any effective control over the money supply would disappear. The net result is that the central bank may become subservient to this objective and to that extent nonresponsive to other central bank functional requirements.

Other criticism involves the effect this plan would have on financial markets. Since the number of new bonds issued would fall dramatically, the value of outstanding bonds would probably greatly increase, providing a windfall gain to present landholders who almost exclusively are the wealthy. Present stockholders, on the other hand, would be adversely affected from the tremendous dilution that results from the immediate issuance of so many new shares. This in turn would have a depressing effect on stock prices.

Financial institutions would be greatly affected. Commercial banks would not have the capability to grant such a volume of loans given the reserve requirement. Also, by accepting so many long-term obligations, the banks would be put into a position of illiquidity. Furthermore, if commercial banks, in effect, became the source of all investment funds, this places all of the other financial intermediaries in our system, which now are playing a significant role in the handling of stocks, in a tenuous position as much of their services are no longer needed and they find their investment outlets closed.

Two problems arise in regard to the participants in the plan. Giving Government the responsibility of selecting the participants creates many problems, for the criteria would be difficult to establish, and it would be difficult to establish a justifiable cutoff point without alienating those who just miss being selected. After the participants have been selected, if the choice of stocks is left to these households, (1) wise or simply early buyers could quickly deplete the supply of "choice stock," and (2) individuals who are not knowledgable and perhaps have never owned stock would be handicapped in making wise choices on a diversified portfolio.

Kelso's plan would close off a major investment outlet for the majority of Americans. Such denial of any type of participation in the corporate sector would certainly be greatly resisted.

Finally, a very serious problem with the plan is the lack of guarantee against recession, during which the dividends to repay the loans on schedule simply would not be available. The fact that the loans may be guaranteed does not solve the problem as this would leave the CDIC, a Government agency, with a tremendous financial obligation to make restitution to the banks which could exacerbate the recession.

One change would alleviate most of the problems cited above—to initiate the plan at a much more modest level. For example, the plan could require that only 15, not 100, percent of all new capital expenditures be financed out of stock that is made available to the plan. Further, corporations could be required to pay out a certain percentage

72-172—76——5

of their earnings as dividends rather than the full payout specified in the plan. Overtime, these percentages could be increased if the plan works well. In a scaled down version, the rediscounting provision, which is the most objectionable part of the plan, could be eliminated. This phased-in system would not break completely with all traditional corporate financing practices and would allow for the plan to be evaluated over time. If successful, the scope of the plan could be increased so that more households could benefit.

The general conclusion concerning the plans discussed in this chapter is as follows:

There are numerous ways to achieve the goal of broadened ownership of new capital. Since this is a goal for all Americans and not just employees of corporations, serious consideration should be given to plans that are open to all individuals so that anyone desiring to purchase stock under special beneficial provisions may do so up to a specified ceiling. The plan should also provide incentives for firms to finance their future capital formation through issuance of new shares of stock as this would serve two purposes: (1) it would enhance economywide efficiency since funds channeled through the capital markets would be allocated to the areas with the highest rates of return and (2) it would help ensure that a significant amount of new stock would be continually available for purchase by individuals. The capital formation plan and the financed capitalist plans are comprehensive programs containing specific provisions to help each of the above objectives. These plans in particular, and others of a similar scope and nature, should be subject to detailed debate within the Federal Government beginning this year so that the people of this country may soon benefit from such programs, both directly through their stock ownership and indirectly through the more efficient economy that would result.

Chapter 3. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Employee Stock Ownership Plans (ESOPs) have received a great deal of attention in the past 2 years, particularly by persons concerned with corporate finance. Companies continue to adopt them and interest in them continues to increase, despite the inconclusive evidence of their usefulness and the sporadic nature of tax incentives favoring them (discussed in appendix A).

The proponents of ESOPs have two specific goals: (1) to provide a company with an additional and cheaper means of financing such objectives as plant expansion, retiring or refinancing debt, acquisitions, and divestitures, and (2) to provide an effective means for the employees of a corporation to become owners of newly issued stock. They maintain that adoption of the plans would stimulate capital formation for the benefit of the economy as well as enable a much greater proportion of the population to own capital. Robert Flint of American Telephone & Telegraph, in testimony before the committee, indicated that "the stated objectives of the plan, favoring a broad base of equity ownership, long-term investment rather than speculation, and employee participation in the ownership of the business, are generally consistent with business positions."

Most discussion of ESOPs, however, has centered on the financial benefits to the corporation, with very little attention paid to the benefits for employees or the potential effect which widespread adoption of ESOPs could have on the economy. Sensing a need for this type of examination, the Joint Economic Committee held 2 days of hearings in December 1975, during which many diverse viewpoints on ESOPs were expressed. Many of the leading experts testified, from both a theoretical and practical perspective. This chapter highlights what was learned at those hearings and in subsequent material that was presented to the committee to fill some of the gaps in current thinking on ESOPs and help resolve the debate over just how beneficial they are for each of the parties involved.

How an ESOP Operates

Although an ESOP can be used for many purposes, most corporations view it first and foremost as a new corporate financial device to help save tax dollars. Proponents of ESOPs, particularly Kelso, have urged the use of ESOPs for financing corporate expansion which, since it involves a loan, is known as a leveraged ESOP. Even though many of the ESOPs currently in existence are not leveraged (as shown in appendix B), the general form of this type of ESOP will be outlined. The corporation would first request a loan from an ordinary lending source. The novel feature of the plan is that the loan is to be made directly to an employee stock ownership trust (ESOT)

which gives its note to the lender. The committee that manages the trust invests the loan. The corporation then guarantees to the lender that it will make annual payments into the ESOT in amounts sufficient to enable the trust to amortize its debt. These payments, within limits specified under section 401(a) of the Internal Revenue Code, are deductible by the corporation as payments to a qualified employee deferred compensation trust.

As the principal and interest payments are made, the shares of stock become free of lien and are allocated to each employee's individual account. The employees are thereby permitted to acquire an ownership interest by increments over a period of years at a price fixed at the time the block of stock is first purchased. Typically, the employee receives his or her vested shares of stock only at retirement or termination of employment. Generally, employees would be fully vested after 10 years of service. Favorable tax treatment is accorded the employee since lump sum distributions of employer stock can be treated as capital gains.

Dividends may be treated in any number of ways. During the financing process, they may be applied to accelerate the repayment of the ESOT loan. They may also be distributed currently to the employee-participants—the "second income" idea favored by Kelso. The level of dividends and how they are used, as shown below, has a significant impact on the tax benefits and the net cost of the plan to the corporation. Concerning voting rights, either the committee appointed by the corporation to manage the trust can exercise the voting rights or they may be passed through to the employees as shares become vested and allocated to their account. After a particular block of stock has been paid for, diversification of investments under the ESOT can be achieved by exchanging the stock, at fair market value, for other shares of equal market value. Such diversification incurs no tax liability since the trust is a tax-exempt entity.

Comparison With Other Employee Benefit Plans

Many commentators on ESOPs have been quick to point out that many employee benefit plans already in existence can be used to put employees in an ownership position. The principal types are profit-sharing plans, thrift and savings plans, and stock purchase or bonus plans;[1] all have much in common with ESOPs. Each is a single firm fund without diversification that enjoys preferential tax treatment. Each is a defined contribution plan which means that the employer's annual contributions are fixed, usually at a flat dollar amount or at a percentage of compensation, and the amount of the employee's benefit depends on the performance of the fund's investment. All are usually broad-based plans covering a wide range of employees.

Yet there are key differences. In a profit-sharing plan (the most widespread employee benefit plan with an estimated 310,000 currently in effect), a corporation gives its employees a share of its profits, with the firm's contribution dependent on the level of profits. Employer contributions to an ESOP do not need to be based on company benefits,

[1] Thrift plans will not be discussed in this section as they require employee contributions, which means that only "savers" will benefit from the plans which is not the case with ESOPs.

which is a critical distinction for it is the ESOPs facility to guarantee company contributions, regardless of profits, that allows the ESOP to be utilized as a technique of corporate finance. Additionally, this permits the corporation with an ESOP to create a net operating loss and recover previously paid Federal income taxes. The two plans also differ in that distribution to participating employees under an ESOP must be in stock, while profit-sharing plans may also be in cash.

Some have maintained that most ESOPs are deferred profit-sharing programs, and certainly this is true of some ESOPs in which the company contribution to the plan each year is related to the profitability and success of the company. When a loan has been made by the ESOP, a minimum contribution adequate to amortize the outstanding loan over the agreed period would continue.

Stock bonus plans up to 1974 and the passage of the Employee Retirement Income Security Act (ERISA), were essentially first cousins to profit-sharing plans. They have the same general rules, including the same 15-percent limitation on contributions based on qualifying payroll. ESOPs are a specialized form of stock bonus plan. Both differ from profit-sharing plans in the two ways mentioned above and in the investment guidelines they are to follow. In general, profit-sharing plans are required to make investments which provide for diversification, liquidity, reasonable return on investment, and purchase of investments at a fair price. The first three of these four criteria do not apply to stock bonus plans.

An ESOP differs from the traditional stock bonus plan primarily in that it must be invested mainly in employer securities while a stock bonus plan need not be. Historically, they have invested a portion of their funds in government bonds, key-man life insurance and the like. The most fundamental difference, however, is the ability of the ESOP to be utilized as a technique of corporate finance. This important distinction was made in ERISA which specifically allows an ESOP to (1) borrow money, with the company guaranteeing repayment of the loan, and (2) to buy stock on an installment basis from a shareholder. In short, an ESOP is basically a stock bonus pblan but one that is designed to allow the trust to utilize company credit as a means of debt financing. This enables employees to acquire larger blocks of employer stock "up front" and therefore at a lower price (assuming the stock appreciates over time) than they could under conventional stock bonus plans. In fact, an ESOP is often used to acquire control of the employer company, whereas a typical stock bonus plan is rarely so used. This leveraging achieved through borrowing is of great benefit to the employee as long as the stock appreciates, but also brings with it the risk of incurring greater losses if the stock value depreciates. It should be noted that, unless the additional appreciation, in value the employees receive on their stock offsets the interest expense, they will receive no net financial advantage from an ESOP over benefits derived from a conventional stock bonus plan.

Advantages

Evaluating the usefulness of ESOPs for corporations and for their employees is not an easy task. Many of the advantages or disadvan-

tages cited by proponents or critics of ESOPs are not definitive, but are based on either tenuous assumptions or partial analysis.

To be sure, some facts can be stated about the value of an ESOP for a company and these will be highlighted. Additionally, some ESOPs are applicable to all situations, but many others apply only to certain kinds of corporations in specific circumstances. Clearly, the ESOP concept is not unambiguous but has many variations which should be recognized by all parties concerned.

Corporations

We will begin with the advantages of ESOPs that are most generally applicable. These revolve around the fact that an ESOP, being a new tool of corporate finance, can be used for a wide variety of purposes which in many cases will achieve goals not attainable through other means.

The primary thrust of ESOPs is to save on taxes. If corporate taxes were repealed, few would remain interested in ESOPs. All of the various financial manipulations described below revolve around this central feature.[2]

First, an ESOP permits a corporation seeking to raise additional capital to take out a loan and repay both the principal and interest with pretax dollars. Conventional loans require repayment of principal with aftertax dollars. This is a significant advantage, for the need to raise new capital is pressing in many industries and the employee group is a logical and convenient concentration of potential new shareholders. For many small, closely held companies, a public offering of securities is not possible, and an ESOP may provide the only means to raise equity capital for expansion.

Second, ESOP financing can help a company avoid going public. Funds can be raised without entailing the substantial disadvantages which accompany going to the public market, trying to arrange a private placement, seeking a merger or undertaking a direct loan. In addition, the fluctuations of a public market need not impinge on the value of the corporate stock in its own "in-house" market.

Third, ESOP financing will allow stock redemption to become tax deductible. Normally, the cash outlay by a corporation for a redemption would not be tax deductible. However, when an ESOP acquires the stock, the corporation's cash contribution to the ESOP to cover the cast of purchasing the stock will be tax deductible. The seller of the stock benefits from the capital gains treatment in selling to the ESOT whereas if the corporation had instead redeemed a portion of the stock, the stockholder most likely would have received dividend treatment.

A company may want the redemption to be complete. "Going private" through using an ESOP as the vehicle for a tender offer to public shareholders provides the advantage that such purchases do not shrink the company's shareholder base. Such actions can strengthen management control of the corporation in all cases where the ESOT stock is voted by the trustee in accordance with the direction of a committee appointed by and serving at the pleasure of the board of directors.

[2] A witness at the committee's hearings on ESOPs who serves as a consultant on ESOPs for a large Wall Street accounting firm, testified in confirmation of this point. He said, "My experience is that without question the overriding initial interest in ESOPs by my clients and those who have attended my lectures is in the favorable tax treatment that they have heard ESOPs provide and in the favorable financing opportunities that derive therefrom."

Fourth, acquisitions may be facilitated. Since a new business activity can usually be purchased at a substantial discount for cash, it would be advantageous for the acquiring company to use cash obtained through an ESOP to buy the new business activity. The pretax savings of the acquired company, and the increased employee compensation base, are available to repay debt incurred for financing the acquisition. Alternatively, the acquiring company's ESOT may buy all of the stock of the new company on an installment basis. The ESOT transfers the new stock to the acquiring company in exchange for equally valued stock of that company. The acquiring company pledges the stock of the acquired company to the seller as collateral in its agreement to make ESOT contributions. A final alternative would be for one corporation to acquire control of another by purchasing a relatively small amount of the acquired corporation's shares, and having the acquired corporation set up an ESOP which buys up the remaining outstanding shares.

Fifth, ESOPs may help corporations that are confronted with the opportunity or obligation to divest themselves of an operating division or subsidiary. Often, a company wishing to "spin off" a subsidiary finds that it cannot promptly obtain a buyer at a fair market price. It can create a shell corporation to acquire the assets of the operating division. The new corporation adopts an ESOT which borrows all or part of the purchase price of the stock of the new corporation. The Shell corporation uses this money to buy the assets of the operating division, which completes the divestiture. Such corporate divestiture may be of special interest to conglomerates seeking to sell off subsidiaries bought during the acquisition craze of the 1960's.

Sixth, an ESOP may be used to refinance existing corporate debt so that it may be repaid with pretax dollars. The ESOT would borrow the amount of the outstanding debt and purchase an equal amount of company stock. The ESOT repays its loan out of the company's deductible contributions to the ESOT. Being repayable with pretax dollars, the loan is paid off more quickly. Also, the balance sheet of the corporation is strengthened through lowering its debt-equity ratio.

Seventh, an ESOP may be used to receive direct stock contributions from the employer which gives rise to a current tax deduction equal to the fair market value of the stock at the time it is contributed. Since no immediate cash outlay is involved, the employer's cash flow is enhanced by the amount of the tax saving. This could be significant to many corporate managements which are developing a growing interest in cash flow concepts in preference to reported earnings. It also should be noted that this positive cash flow may even be available where the contribution gives rise to or increases a current year net operating loss if the loss can be carried back to prior years to obtain a tax refund. For example, if the firm had a taxable income of $1 million over the past 3 years and breaks even in the fourth, it can contribute $1 million (if the 15-percent limitation permits) to an ESOT and establish an operating loss. This entitles it to a refund of all taxes paid the prior 3 years.

The uses of ESOPs cited above apply generally to all companies. For the most part, however, ESOPs have not been adopted by a representative sample of companies, but rather by relatively small,

closely held corporations. Therefore, one may wish to single out from the general list the particular uses and attractiveness of ESOPs to these types of companies.[3]

ESOPs provide a ready market for the stock of a major shareholder who wishes to dispose of all or part of his or her holdings. This stock is purchased by the ESOP at fair market value and paid for with the tax-free dollars that the ESOP receives from the company. The selling shareholder benefits, for any profit realized on the sale will be given capital gains treatment, as an IRS ruling has stated that the stock is not being redeemed by the corporation but by a separate independent legal entity. If redeemed by the corporation, the transaction may be treated as a redemption, resulting in taxation of the sale at ordinary income rates. Also, owners can essentially eliminate the double taxation of dividends by remaining high-salaried employees and transferring retained corporated earnings into the ESOT, vesting trust assets in proportion to contribution or salary. This is of great benefit to owner-managers approaching retirement who can use this pretax contribution to transfer equity ownership into an accumulation of income under the trust which will be less heavily taxed.

ESOPs also make "buy and sell" agreements, used to facilitate estate planning, more attractive. The ESOT agrees to buy from the stockholder any number of shares he or she wishes to sell to it, and buys life insurance on the individual equal to the value of those shares. Thus, the ESOT buys the stock upon the death of the shareholder with insurance proceeds that are purchased with tax-free premiums. This increases the estate's liquidity and reduces the uncertainty of estate planning as the value of such stock for estate tax purposes is definitive, eliminating speculation on what the ultimate price may be after negotiation with the IRS.

In addition to the financial and tax advantages afforded by ESOPs, all corporations may benefit through the effect of ESOP participation on employees. The point is a simple one. Providing the employees with an ownership stake in the company should enhance their motivation on the job, which in turn will increase their productivity. Kelso has stated this point quite categorically, pointing to "the improved motivation that all evidence shows to exist where employees are aware that they are acquiring a growing ownership in their employer" and the "fact" that "there is no way to raise the economic productiveness of a mature worker except by building capital ownership into him." With regard to the first statement, certainly "all evidence" does not indicate increased motivation. Quite to the contrary, many analyses have shown the tenuous connection between the acquisition of stocks by employees and increased motivation. This would be particularly true for lower echelon workers who obtain few shares. Improved worker motivation is not such a clear advantage for corporations as are the financial and tax benefits.

To conclude this section, the types of industries or companies most likely to benefit from ESOPs generally will be highlighted. Because

[2] Kelso, despite the fact that most of his writings emphasize ESCOPs as a technique of corporate finance which will stimulate capital formation, maintains that diffusing stock ownership as the owners of closely held corporations die is equally as important: "Achieving the goal of broad capital ownership, ultimately by all consumer units in the U.S. economy, is as much dependent upon assuring that as generations of capital owners die, the method of succession used advances this goal, as it is upon broadening ownership in the course of financing expansion."

the tax-deductible ESOP contribution is usually limited to 15 percent of covered payroll, the companies which can "shelter" a greater portion of their taxable income through an ESOT are those in labor-intensive industries. Since labor is a more significant factor in these industries, it also follows that the employee motivation factor is more likely to be a significant one. Thus, it is possible that widespread adoption of ESOPs could affect factor proportions in some sectors.

Service industries are more likely to find ESOPs attractive than manufacturing companies, not only because they tend to be more labor intensive, but because of two structural factors unique to them. Because these companies often do not have unions, they might find an ESOP to be a valuable means of making it less likely that their workers will join a union. Also, since these companies do not have the physical collateral often required to obtain traditional financing, they would more likely welcome that function of ESOPs.

Employees

The brevity of this section on the advantages of ESOPs to employees may be surprising, since under law, ESOPs "must be for the exclusive benefit of participants or their beneficiaries." The reason is that employee benefits are few in number, fairly straightforward, and not subject to much analysis or debate in the writings or talks given on ESOPs, while corporate advantages are many, complex, and the subject of at least 90 percent of all analysis of ESOPs.

With ESOPs, employees can obtain an ownership interest in the employer corporation without any immediate cash outlay, and without incurring any income tax liability until shares from the plan are distributed to them. Even then, methods are available to cushion the tax impact of lump sum distribution. Additionally, any appreciation in the value of the employees' stock in the ESOT goes untaxed until the shares are actually sold, and they are then taxed at long-term capital gains rates. If a participant dies, the beneficiary (if other than the executor of the estate) who receives the shares would not be subject to Federal estate taxes.

If the stock increases in value over time, the employee benefits from the leverage the trust receives by being able to utilize company credit. The unrealized appreciation accruing to the ESOP participants will be greater as a result of the ESOTs acquiring a large block of the employer's stock at the outset and thus holding it for a longer period of time than annual stock contributions would permit.

Disadvantages and Problems

In the previous discussion, the advantages of ESOPs were presented in unqualified form, leaving to this section the problems that may be encountered. At the outset, the widely recognized problem of dilution that may affect the existing public stockholders must be mentioned as it should influence the decision of all public corporations whether or not to adopt an ESOP.

Existing Stockholders—The Dilution Problem

In the case of a leveraged ESOP, dilution stems from the fact that the ESOT loan must be repaid and dividends on the ESOT shares will not be sufficient to cover both interest and repayment of principal.

Thus, unless the plan is funded through increased prices of the corporate product, the repayment of principal creates an additional charge against corporate net income. This has a diluting effect on earnings per share and book value of existing shareowners similar to the effect of existing stock bonus or stock option plans.

The amount of dilution, of course, depends on the return on the investment made with the loan proceeds. It also depends, however, on whether the company's stock is purchased directly from the company or from existing shareholders. As shown in the example below, the contribution of shares to the ESOT by the company which means an increase in the number of shares outstanding, would mean even further dilution of earnings per share.[4]

	Example A—No ESOP	Example B—ESOP buys shares from existing stockholders	Example C—sponsoring company contributes shares to the ESOP
Pretax earnings	$1, 000, 000	$1, 000, 000	$1, 000, 000
Assumed ESOP contribution		[1] 100, 000	[2] 100, 000
Adjusted pretax earnings	1, 000, 000	900, 000	900, 000
Assumed income taxes at 50 percent	500, 000	450, 000	450, 000
Aftertax earnings	500, 000	450, 000	450, 000
Earnings per share [3]	50. 00	45. 00	40. 90
Effect on cash flow versus example A		(50, 000)	50, 000

[1] Cash.
[2] Stock.
[3] Assume 10,000 shares originally outstanding. In example C assume that 1,000 additional shares are issued with a fair market value of $100 per share to cover the contribution of $100,000.

For the closely held corporation, the situation is somewhat different. Since such companies rarely pay dividends, the compounding effect of reinvested earnings is lost. This means that any increases in the value of the stock must come from the success of the company, as it is not possible to offset the dilution factor with earnings generated by the stock.

Employees

Declining companies and company failures is a central concern for employee stockholders, particularly for those under a leveraged ESOP, since if the company declines, they are in debt to the lender with no "second income" or self-liquidating yield to protect them. Proponents of ESOPs like to make it sound as though business failures will not be a problem under a system of widespread ESOP adoption since more capital is provided and worker productivity is increased. If so, then ESOPs have some job to do since 60 to 70 percent of all businesses decline during the working life of an employee (40 years). Another estimate is that in recent years, between 350,000 and 400,000 firms are discontinued each year. Furthermore, there are numerous causes for failure which are beyond the influence of employees. Yet employees are in double jeopardy: they risk losing not only their jobs, but also their retirement nest eggs. In case of failure, the stockholder is paid for loss only after all creditors are satis-

[4] This example is based on one found in: Standard Research Consultants, "ESOPs Are an Enticing Employee Benefit Program—But Not For Everyone," SRC Quarterly Reports, summer 1975.

fied, so employee stock ownership is even less protection than the creditor status of an unfunded retirement plan.

Related closely to the magnified hardship of company failure or decline is the matter of leveraging bestowed on the employee when a loan is made by the ESOT. For example, assume that the ESOT borrows 90 percent of the purchase price for publicly traded shares. If the market value of the stock declined by only 10 percent, this would completely wipe out the equity of the participants' accounts.

An extreme example would be the use of an ESOP by a closely held corporation to create a market for their stock, under terms and conditions dictated by the seller and free from governmental regulations, to facilitate a corporate bailout. In this way, the owners could pass on to their employees rather than their heirs the corporate securities whose value is declining and which have no liquidity. In some cases the employees will be able to revive the company's fortune and make it successful where the entrepreneur owner could not. But it must be recognized that in most such cases, the owner would simply get out of a bad situation at the expense of the employees and the government.

A second major problem with ESOP financing for the employees is that during at least the first few years it magnifies their risk by violating a basic principle of wise portfolio management, i.e., diversification. After the initial loan is repaid, the ESOT may diversify its stockholdings to a degree, but this still leaves a period of many years when the employees have "all their eggs in one basket." During this time, workers may be locked into one stock which has a low yield, but their trust is not allowed to shift freely to higher yielding stocks.

Another issue of considerable interest to the employees is whether they will be receiving annual dividend payments and if so, whether the amount will be substantial. Under leveraged ESOPs, where issuance of stock is tied to investment of the newly acquired funds, the amount of stock which an employee can accumulate is dependent on the extent of capital investment planned by the company. This uncertainty about the amount of stock an employee will receive, coupled with the fact that the price of stock my fluctuate, makes it virtually impossible to give employees an estimate of how great their "second income" will be. The only thing certain is that, if a meaningful amount is defined as 20 percent of salary, as one witness at the JEC hearings suggested, then it will be a long time—25 years approximately—before second incomes become meaningful to employees (this assumes a 6-percent compound increase in salary, 11 percent appreciation of invested assets, and a 3-percent dividend payment). This means that the older worker, who will not be working 25 years from now, will never receive dividends that are a significant percentage of salary. Under these assumptions, the worker who is 50 years old and will retire at age 65 will be receiving dividends in the last working year amounting to less than 10 percent of salary.

This is not to say that the payment of dividends under an ESOP is not important, as following example clearly shows. Suppose a company with 100 employees and a payroll of $1 million set up an ESOP which borrowed $1 million for 10 years at 8 percent interest. The amortization payment, and hence the annual tax-deductible contribution to the trust, would be $149,029. Assuming there were zero net

earnings each year after contributions, and barring stock appreciation in excess of inflation, the value of the stock after 10 years would be $1 million in constant dollars, which gives a $10,000 value for the average worker's portfolio. Had the workers received a $1,500 bonus each year, instead of the company having to make an annual $149,029 payment, and put it in a 5-percent savings account, the total accumulated amount would be $18,865, considerably higher than the stock portfolio. Finally, let us assume that dividends are paid on the stock held by the ESOT, but that they are plowed back into the ESOT. If the company had earned a 10-percent aftertax return on capital each year, the portfolio per worker after 10 years would be $22,578. Thus, paying out a larger share of their earnings in the form of dividends could contribute to the economic success of ESOPs.

To conclude this section, some of the main objections of organized labor to ESOPs will be briefly highlighted. Although labor has taken virtually no part in the debate on ESOPs so far, the AFL–CIO and major unions have made it clear they do not support the idea. Unions fear that this device will destroy or at least undermine collective bargaining by making the worker identify more closely with the company. They are also skeptical about employer assurances that the stock allocated to the workers will not merely be substituted for wages or other benefits. Other concerns are that ESOPs could potentially undermine the security of pension funds (if their asset holdings are dominated by corporate stock), benefit high-income executives only, lead workers to take unnecessarily high risks, and result in substantial Federal revenue losses.

Corporations

One of the most fundamental problems of the ESOP concept for corporations results from trying to use an employee benefit plan, which could be a provider of retirement income, as a leveraged corporate finance mechanism. The simple fact is that the objectives of a plan which by law must be designed exclusively for the benefit of the participating employees may not be consistent with capital formation. Thus, it may be possible in some circumstances that under ERISA an ESOP would not be permitted to invest primarily in employer stocks. A similar conflict of interest may arise if the ESOP is used to facilitate estate planning. Since major stockholders would gain most in such cases, such use might be found in violation of the exclusive benefit rule. Furthermore, an ESOP established for this purpose might actually constitute a prohibited transaction, since it could be considered a use of plan assets for the benefit of a party in interest, in violation of both ERISA and the Internal Revenue Code.

If the employer's financial condition declines, the problems are compounded by the existence of an ESOP. Since the value of the stock will very likely diminish, the ESOT will have acquired it at a price higher than when it is distributed to employees. This could create serious problems for the ESOT under ERISA provisions and may even encourage litigation by the participants, particularly if the ESOP is the only retirement program offered by the employer. Additionally, as the stock price deteriorates, the ESOT fiduciaries may be obligated to dispose of the stock held by the ESOT in order to prevent further losses. If the shares have no market (even if the shares are publicly

traded, they may not be salable unless registered), the fiduciaries may be required to insist that the employer be liquidated.

The need to buy back the stock from the employees when they terminate their employment with the company, particularly for closely held companies, offsets to some degree the tax-deductibility advantages of ESOPs. The employees may receive their benefits in two ways: (1) A lump-sum cash distribution or monthly allotment, or (2) a distribution in-kind of the shares allocated to each ESOP participant. Under the first method, an ESOP could have considerable cash flow requirements after operating a number of years if all of the money is invested in company stock and if substantial cash payments are required for terminating employees. With in-kind distribution, a considerable number of shares possibly might be issued annually with unpredictable results. If terminating employees sold their shares as soon as they were issued, a circumstance could arise where the ready availability of the number of shares for sale each year could be large enough to have a depressing effect on the market value of the stock.

In circumstances of cash distribution, the ESOP will not enable the employer to conserve cash permanently by in-kind distribution of stock. Thus, the stock distribution will only be temporary, being replaced at the employees' termination of employment with cash of equivalent value. In effect, the ESOT is borrowing from the employees' termination funds and lending it to the company until termination. The company pays interest in the form of the increased value of the shares during the period they are held. In the absence of the tax deferral to employers provided by qualified plans, an ESOP does not offer a cash advantage but rather a mere deferral of cash compensation.

Different cash outlays are involved for a closely held corporation and a public company. The closely held corporation with an ESOP which starts out by increasing cash flow through tax deductions requiring no cash outlays, will have to make a potentially significant nondeductible cash outlay (unless the ESOP purchases the stock, in which case the stock is not retired to reacquire stock from terminated participants. The aftertax cost of this postemployment income represents the employer's expense of furnishing that compensation and can be considered a cost of the dilution created by the ESOP.

A publicly owned corporation, where the terminated participants can sell their stock on the market, will realize a permanent cash infusion equal to the tax deduction from stock contributions to the ESOT, or about 48 percent of earnings for a corporation paying taxes at the maximum rate. However, this will only be roughly half the amount it could have raised by making a public offering of new shares. The overall result is that the company's earnings per share and book value per share, both of which may affect its stock prices, will be affected by the dilution and the charge to earnings for the contributed stock.

A fourth potential problem area, which exists only for closely held companies, involves the difficulty of valuation of stocks to determine tax deductions and the price at which the ESOP will try to sell stock.

Independent stock valuations are usually quite expensive and may be prohibitively so for many small corporations. Moreover, since valuation is still a very inexact science, the IRS may differ with the valuation. The fact that one cannot obtain an advance determination by the

IRS is a serious problem since the value price affects all ESOT transactions. An IRS challenge on valuation can be particularly troublesome if the shares are sold by the employer or by a major shareholder to the ESOP for a price higher than its market value as determined by the IRS, for the purchase constitutes both a breach of fiduciary duty and a prohibited transaction. If there is a prohibited transaction, the disqualified person is subject to a 5-percent per annum excise tax based on the transaction amount. If not corrected within a limited period of time after IRS notification, a 100-percent excise tax can be assessed. These potential excise taxes are a significant threat to employers who must sell stock to an ESOP on the basis of a good faith market value determination.

A further qualification to the value of ESOPs is the uncertainty that any really significant increases in employee motivation or productivity will result. When the U.S. Railway Association considered adopting an ESOP as a mechanism for financing the capitalization requirements of ConRail, they looked extensively into this topic.

At the JEC hearings on ESOPs, their vice president for financial planning presented their conclusions, which most likely could apply to all large companies. Three reasons were cited why "motivation would not be materially enhanced": (1) In large organizations, employees do not see the results of their own efforts on net income; (2) the individual's share of the ESOP stock would probably not reach a level high enough to alter behavior; and (3) the existence of large numbers of older employees would dampen the motivational impact because of fewer years to accumulate stock and less meaningful expectation of dividends.

The U.S.R.A. statement also pointed out that other motivational research has shown the minimum ratio of dividends to wages effective as an incentive to be between 20 percent and 35 percent for middle-income employees. Thus, payment of annual dividends below 20 percent of the employee's current earnings would not have an appreciable effect on increasing productivity and, as indicated in an earlier section, this level would not be reached for as many as 25 years under reasonably optimistic assumptions. Another witness before the JEC, the financial vice president of A.T. & T., cited evidence gathered in empirical studies on the sources of productivity to concur in the conclusion that productivity gains from more employee ownership of capital are likely to be small. He also pointed out that labor already receives such a large share of national income that shifting some of the 12-percent share now going to stockholders would not have sufficient impact or leverage to provide the extra incentive needed to achieve dramatic productivity improvements.

A final factor that may hinder increased employee motivation is that a relatively small number of shares of stock gradually accruing to a trust account simply will not motivate workers who are more concerned about direct labor compensation. In such a situation, employees may feel no control over what they have been told belongs to them, a problem with all retirement plans. Even if they recognize these stockholdings as additional compensation, they would still continue to press for improvements that they could use immediately.

A final major problem for corporations is that the core advantage of ESOPs, the tax savings they generate, is not the complete advantage which proponents claim it is. First, the tax deductibility of principal and interest payments is enjoyed only as a consequence of the reduced corporate earnings after the principal and interest payments are deducted from income. The tax advantages also arise from the payment to the employees of an equity interest in the company and not because of any unique or "magical," properties of ESOPs. These same tax advantages could be derived through a variety of compensation programs to the employees.

Perhaps the biggest problem related to the tax advantages of an ESOP is that many companies have such a low effective tax rate that they would not be attracted to ESOPs because of tax advantages. For example, the overall effective tax rate is 38 percent, well below the nominal 48-percent rate. Many companies, however, have a much lower effective rate and thus would not be interested in ESOPs. This is quite significant because many of the largest corporations in America are included (the figures are the U.S. rate on their worldwide 1974 income): ITT (7.5), Westinghouse (3.0), Bank of America (6.6), Citicrop (4.6), Union Carbide (15.9), G. D. Searle (6.2), Safeway Stores (16.2), Atlantic Richfield (7.9), Exxon (6.4), Gulf (2.9), Goodyear (12.1), and Commonwealth Edison (15.2).

This factor alone is sufficient evidence to conclude that ESOPs will very likely not have a significant impact on the economy in the near future.

Comparison With Other Financing Techniques

Proponents of ESOPs hail them as a new means of corporate finance that will bring great financial advantages to companies through the tax deductibility of both the principal and interest payments on the loan. The further claim often is made that because of this attraction, the great capital formation needs of the future can be largely met through this new tool for generating capital. Therefore, to test the claim that ESOPs can assist significantly in capital formation, we must determine just how attractive they are to corporations. If they fail this test, their impact on capital formation will be small.

Comparison has been made between an ESOP and a conventional loan with the company contributing stock to an ESOT by a number of economic and financial analysts, who have reached the same conclusion: the financial results of these two methods of financing are essentially the same.[5]

To illustrate, assume that instead of an ESOP borrowing $1 million to purchase 100,000 shares of employer stock, the employer borrows the money directly from a bank and contributes 20,000 shares of its stock to an ESOP in each of the 5 years of the loan repayment period. If the fair market value of the stock remains the same during the period, under each of the two methods (1) the employees will, through

---

[5] W. Gordon Binns, "ESOPs: A joint Piece of Action." Financial Executive: Price-Waterhouse, statement submitted subsequent to JEC hearings on ESOPs; Richard Musgrave, statement submitted subsequent to JFC hearings on ESOPs.

the trust, own 100,000 shares; (2) there will be 100,000 additional shares of the employer's outstanding stock, and (3) the net cash retained will be just about the same. If, on the other hand, the stock's value increases over the 5-year period, the employer's tax deductions under the stock contribution alternative will be larger. The "direct bank borrowing with stock contribution" method also avoids the possibility of a prohibited transaction (when the IRS considers the price paid for the stock by the ESOP to be too high) and allows for the ESOT to be more flexibly structured. In addition, a timing advantage is gained since the tax deduction can be generated at the outset of the loan repayment period while still having the use of borrowed funds, whereas the deduction under ESOP financing can only be taken by giving the funds back to the plan as the loan is repaid.

It should be noted that the situation is the same if, instead of the company contributing stock to the trust, it contributes cash which the trust then invests in the shares of the company. Professor Musgrave, in a written statement to the JEC, pointed this out:

> The company finds its real assets expanded, the debt has been paid off and the trust is in possession of additional shares * * * In short, the outcome of the Kelso procedure is precisely the same as for direct borrowing, provided that trust-fund receipts are reinvested in the company.

It is important, too, that when the company contributes stock to the trust, it can choose the amount it will contribute and therefore the tax deductions could be greater than or less than those obtained under the ESOP. This implies that the extra tax deductions obtained by an ESOP, which equal the loan principal, result by coincidence. Basically, the company has simply elected to give away $1 million in stock to its employees and it is to this gift, and not the repayment of the tax deductible principal, that the additional $1 million tax deduction is related.

A numerical example will help to clarify many of the points in this section. The following facts will be assumed about the XYZ Corp.: It has $1 million annual after-tax earnings; 500,000 shares outstanding, each with a fair market value of $10; and it needs $1 million for plant expansion. Note below the difference between a conventional loan to be repaid in 10 years with $600,000 of interest and an ESOP which purchases 100,000 shares. [In the following examples, parentheses indicate the number is negative.]

Loan proceeds	$1,000,000
Repay loan:	
Principal	(1,000,000)
Interest-tax deductible	(600,000)
Tax benefit of interest deduction	300,000
Cash and net worth	(300,000)
Shares stock outstanding	500,000

Leveraged ESOP

"Sale" of 100,000 shares at $10	$1,000,000
Cash contributions (deductible to ESOP)	(1,600,000)
Tax benefit of ESOP contributions	800,000
Cash and net worth	200,000

This shows that an ESOP does indeed increase cash plus corporate net worth (by $500,000). This benefit, however, is not free. The "price" takes the form of the 100,000 additional shares issued to achieve the $500,000 which constitutes a net cash inflow of $5 per share when stock is worth $10 per share.

This "price" is shown implicitly in the following example which depicts what happens when the stock is sold at $9 (allowing for issuance costs) rather than given to employees.

Conventional loan with stock sale

Loan proceeds	$1,000,000
Repay loan:	
Principal	(1,000,000)
Interest	(600,000)
Tax benefit of interest deduction	300,000
Sub-total, conventional loan	(300,000)
Sale of 100,000 shares at $9 net	900,000
Cash and net worth (versus $200,000 increase for ESOP financing)	600,000

The bottom line makes clear that it would have been less expensive to borrow conventionally, forego tax deductible principal repayments, and sell the stock at its fair market value.

A further example will show the different effects that equity, debt, and ESOP financing have on the corporation's net income, total assets and earnings per share. The base case is a company with $100,000 in assets and $100,000 in shareholders' equity which chooses to grow solely through retained earnings. Three other cases show the company raising an additional $50,000 in capital by the unions means of a direct loan (debt financing), an offering of new shares of common stock (equity financing) and debt financing through an ESOP (ESOP financing). The assumptions underlying the analysis are: (1) a 20 percent return on assets; (2) a 50 percent effective tax rate; (3) no dividends; (4) the loans are placed at 8 percent interest for 5 years; (5) initially there are 10,000 shares of common stock outstanding, the ESOP then buying 5,000 new shares; and (6) the stock price remains constant at $10 per share.

Over a 10-year period, the major financial results are as follows. Net income is highest under equity financing for the entire 10-year period. For the other three forms of financing, the period must be split in half, for the ESOP case provides the least net income during the 5-year loan period, but the greatest net income after the expiration of the ESOP's loan. This excess of earnings later in the period under ESOP financing is due to the fact that there is more rapid accumulation of assets in the ESOP case because of the sheltering of taxes. Equity financing, however, yields the greatest total assets throughout the period. Finally, earnings per share (EPS) throughout the 10 years would be lowest in the ESOP case, highest under debt financing, with the base and equity financing cases providing an identical intermediate path.

This last point concerning the EPS highlights where the cost of an ESOP is likely to fall. Clearly the cost of is not borne by employees

or the corporation and even the U.S. Treasury may recover much of the immediately lost tax revenue when employees are taxed upon distribution of the stock. This leaves the present shareholders who, through dilution of their stock interest, are likely to end up paying for the ESOP. Using the XYZ Corp. described earlier in this section, the following table conveys the dilution effect of ESOP financing relative to a conventional loan.

TABLE 5.—DILUTION EFFECT FROM ESOP FINANCING

	Conventional loans	ESOP
Earnings, 10 yr	$10,000,000	$10,000,000
Net cash (from previous example)	(300,000)	200,000
Cash and net worth	9,700,000	10,200,000
Total financial statement earnings, 10 yr	9,700,000	9,200,000
Interest of prior shareholders in net worth and future earnings (percent)	100	83⅓

This example shows the importance of the use to which new capital is put. Proponents of ESOPs often dismiss the dilution problem by assuming a very high after-tax return on the investment made with the dollars channeled through the ESOP. Certainly this may be true in some cases, but not all companies will be able to achieve rates of return high enough to avoid dilution for existing shareholders.

These existing shareholders also are affected whenever the ESOP is used to acquire stock from any of them. ESOP proponents claim that use of an ESOP for this purpose will bring the company great savings, citing examples such as the following. If a company with a 50 percent tax rate wishes to acquire 100,000 shares of outstanding stock at $8 per share, it would need $1.6 million of pretax earnings. Utilizing an ESOP, it would only need $800,000 to acquire the stock. In addition, the shareholders selling their stock would receive capital gains treatment rather than having their income taxed as ordinary income.

To see how the remaining existing shareholders are picking up the tab for these savings, we will once again use an example the XYZ Corp. The additional assumption is that the company has two shareholders, one of whom owns 60 percent and wants to sell this interest now for $3 million cash. The $3-million loan needed to acquire the stock may be made either directly to the company or indirectly through an ESOP. The net result after the 10-year period of the loan is that the cumulative cash and net worth increase would be $7.6 million under an ESOP and $6.1 million under a stock redemption, with the number of shares outstanding being 500,000 and 200,000 respectively. Though the greater cash flow increase under the ESOP looks good, it is far outweighed by the value, in terms of share of future annual earnings, given up by the remaining shareholders as shown in the following table.

TABLE 6.—EFFECT OF ESOP FINANCING ON REMAINING SHAREHOLDERS

	ESOP (40-percent owner)	Redemption (100-percent owner)
Total book value—end of 10 yr	$7,600,000	$6,100,000
Share of book value	3,040,000	6,100,000
Share of future annual earnings	400,000	1,000,000

A study prepared for the Joint Economic Committee by Mr. Steven Seeberg is of particular value and interest in comparing ESOPs with other means of corporate finance, as it is based on a comprehensive corporate financial model. The model takes into account the multiple interacting variables which affect the financial results from various methods of corporate finance. Thus, it is able to specify under what types of conditions an ESOP may or may not benefit a company.

The study looked at two hypothetical companies, one of which had no annual deferred compensation expense other than its pension plan contributions prior to the financing (company A) while the other incurred additional expense equal to 15 percent of covered payroll prior to the financing and thus the ESOP simply substituted for prior outlays (company B). Their objective was to refinance a $15 million loan becoming payable in 1978.

A subsequent analysis was done to determine whether the results highlighted below for each of the financing alternatives would still hold if the $15 million were used for expansion purposes rather than refinancing the existing debt. Apart from slight numerical differences, the results are the same, with each financing alternative maintaining its comparative advantage or disadvantage.[6] Thus, the results are generally applicable for companies considering the adoption of an ESOP.

Both companies had two goals in refinancing the loan: (1) to maintain acceptable annual growth rates in earnings per share (EPS) which was assumed to have been 7 percent up to 1978, and (2) if possible to maintain or improve their debt-equity ratios. Their four basic financing alternatives were conventional corporate debt (base) and equity financing (equity) as well as a leveraged ESOP (ESOP loan) and an ESOP used in conjunction with conventional corporate debt, in which annual contributions of stock are made to the plan equaling the annual loan principal payments (ESOP stock). Additionally, Company B engaged in a third type of ESOP financing which involved purchasing stock with the funds from the company's profit-sharing plan that had been converted to an ESOP (ESOP Conv. from PSP). These alternatives were projected over a twenty year period beginning

[6] There are two reasons for the unchanging relationship. First, when the capital is used for expansion, 1979 earnings for each financing alternative will be decreased by the same amount, namely, the interest (after tax) payable on the loan that was not refinanced. Since the number of shares outstanding during the study periods of 1977–78 and 1978–79 remain unchanged, the earnings per share fraction for each financing alternative would be affected proportionately. Second, the particular financing alternative selected did not affect the return on expansion capital under the study's assumption that the ESOP techniques did not increase productivity.

with 1976 at price-earning (P–E) multiples of 5, 11 and 30. The major results for each type of financing are shown in table 7 and are highlighted as follows:

TABLE 7.—RESULTS OF ALTERNATIVE FINANCING TECHNIQUES ON EARNINGS PER SHARE AND DEBT/EQUITY RATIOS

Price/earnings multiply	Alternatives	Weighted average earnings per share				Percent increase or (decrease) of weighted average earnings per share		Debt/equity ratio	
		1977	1978	1979	1995	1977–78	1978–79	1977	1978
(1)	(2)	(3)				(4)		(5)	
	COMPANY A								
5	Base	1.20	1.29	1.40	5.30	7.5	8.5	.41	.38
5	ESOP loan	1.20	1.08	1.21	3.37	(10.0)	12.0	.41	.37
5	ESOP stock	1.20	1.20	1.21	3.55	0	.8	.41	.36
5	Equity	1.20	1.29	1.01	3.65	7.5	(21.7)	.41	.04
11	Base	1.20	1.29	1.40	5.30	7.5	8.5	.41	.38
11	ESOP loan	1.20	1.08	1.25	4.12	(10.0)	(15.7)	.41	.37
11	Equity	1.20	1.29	1.24	4.46	7.5	(3.9)	.41	.04
11	ESOP stock	1.20	1.20	1.26	4.30	0	.5	.41	.36
30	Base	1.20	1.29	1.40	5.30	7.5	8.5	.41	.38
30	Equity	1.20	1.29	1.40	5.05	7.5	8.5	.41	.04
30	ESOP loan	1.20	1.08	1.28	4.66	(10.0)	18.5	.41	.37
30	ESOP stock	1.20	1.20	1.29	4.76	0	7.5	.41	.36
	COMPANY B								
5	Base	.97	1.04	1.12	4.13	7.2	7.7	.43	.43
5	ESOP loan	.97	1.04	1.08	2.65	7.2	3.9	.43	.40
5	ESOP stock	.97	1.04	1.04	2.84	7.2	0	.43	.40
5	Equity	.97	1.04	.76	2.65	7.2	(26.9)	.43	.07
5	ESOP Con. from PSP	.97	1.04	.76	2.65	7.2	(26.9)	.43	.07
11	ESOP loan	.97	1.04	1.15	3.35	7.2	10.6	.43	.40
11	Base	.97	1.04	1.12	4.13	7.2	7.7	.43	.43
11	ESOP stock	.97	1.04	1.09	3.54	7.2	4.8	.43	.40
11	Equity	.97	1.04	.96	3.35	7.2	(7.7)	.43	.07
11	ESOP Conv. from PSP	.97	1.04	.96	3.35	7.2	(7.7)	.43	.07
30	ESOP loan	.97	1.04	1.20	3.90	7.2	15.4	.43	.40
30	Base	.97	1.04	1.12	4.13	7.2	7.7	.43	.43
30	Equity	.97	1.04	1.12	3.90	7.2	7.7	.43	.07
30	ESOP Conv. from PSP	.97	1.04	1.12	3.90	7.2	7.7	.43	.07
30	ESOP stock	.97	1.04	1.11	3.99	7.2	6.7	.43	.40

Conventional corporate debt financing achieved both goals at all P–E multiples for both companies. In fact, it produced the largest total increase in EPS and the greatest EPS in 1995, while improving the debt-equity ratio of company A and maintaining that of company B.

The equity alternative did very well in achieving the debt-equity goal, bringing about the greatest improvement in this ratio for both companies at all multiples. However, it produced acceptable increases in EPS only at the study multiple of 30 due to dilution at lower P–E multiples.

The ESOP alternative had similar results in regard to the two goals. All of the ESOP alternatives improved the debt-equity ratio of both companies at all study multiples. Significantly, achieving the EPS goal depend on factors other than the type of ESOP used. For company A, where additional plan contributions were required to implement the ESOP, no ESOP technique at any multiple produced ac-

ceptable increases in EPS. When such expense was incurred prior to the financing as in company B, ESOPs became acceptable methods at multiples of 11 and 30.

Some interesting comparisons may be drawn between the ESOP and equity alternatives in regard to meeting the EPS goal. For company B, all ESOP techniques (except those involving the contribution of stock at the multiple of 30) produced comparable or larger increases in EPS than equity financing. However, for company A, the relative merits of ESOP techniques in this regard varied according to the P–E multiple used. The higher the multiple, the less favorably ESOPs compared with equity. This is because dilution, which is more pronounced in the equity case at the outset, becomes less of a problem the higher the multiple. At lower multiples, on the other hand, the ESOP's dilution plus the additional expense required combined do not lower the EPS as much as the full one-shot dilution effect under equity financing. However, by the end of the 20-year period, all ESOP techniques for company A produced smaller EPS at all multiples. This suggests that for companies where additional contributions are required to implement the ESOP, ESOPs may produce greater EPS in the years of the financing if the multiple is low, but over the long term, are likely to be more expensive for the company than either debt or equity. This is due to the continuing plan contribution expense incurred under the ESOP alternative as opposed to the one-shot dilution which occurs at the outset in the equity alternative. The results cited above can shed light on what types of tax incentives, if they are deemed desirable, would be most efficient. These are discussed in the final section of this chapter.

Many businesses considering ESOPs and individuals interested in socio-economic policy are asking whether the employees under an ESOP are likely to become majority owners and therefore obtain effectvie control over the company. Seeberg's study helps to answer that question by determining what percent of each of the two companies would be owned by the employees in 1979, 1983 and 1995. Since the Base and Equity cases do not provide employee ownership, table 8 shows only the results for the three types of ESOP financing alternatives in this study.

TABLE 8.—PERCENT OF COMPANY OWNED BY EMPLOYEES UNDER VARIOUS FINANCING ALTERNATIVES

P–E multiple	Alternative	Percent owned in— 1979	1983	1995
Company A:				
5	ESOP loan	6.7	20.0	33.3
5	ESOP stock	6.8	19.3	29.8
11	ESOP loan	3.7	11.1	18.5
11	ESOP stock	3.2	9.4	15.0
30	ESOP loan	1.5	4.6	9.3
30	ESOP stock	1.2	3.6	5.8
Company B:				
5	ESOP loan	7.7	23.0	38.2
5	ESOP stock	8.1	22.1	33.7
5	ESOP Conv. from PSP	38.3	38.3	38.3
11	ESOP	4.4	13.2	22.0
11	ESOP	3.8	10.8	17.2
11	ESOP Conv. from PSP	22.0	22.0	22.0
30	ESOP loan	1.9	5.6	9.4
30	ESOP stock	1.4	4.1	6.7
30	ESOP Conv. from PSP	9.4	9.4	9.4

In virtually all cases (except a P–E multiple of 5 for 1979), the ESOP loan alternative provided greater employee ownership than the ESOP stock alternative. In general, the lower the P–E multiple, the greater would be the extent of the employee's ownership. Ownership would be slightly higher in companies where no additional plan contributions would be required. Of course, if such a company were converting a profit-sharing plan into an ESOP, the ownership interest would be the greatest by far. In no case, however, did employee ownership come close to majority ownership, even by 1995.

The final area covered in Seeberg's study was the dollar benefit of the financing alternatives to employees at salary levels of $10,000, $30,000, and $50,000. These economic effects on employees were depicted in terms of "annual distributable income" (ADI) which is dividends and interest from trust assets, and "accumulated trust equity" (ATE) which represents the amount in each participant's account resulting from plan contributions and assets purchased with such contributions compounded at 6.5 percent. The results are shown in table 9.

TABLE 9.—DOLLAR BENEFITS FOR EMPLOYEES UNDER VARIOUS FINANCING ALTERNATIVES

P–E multiple	Alternative	Employee with 1976 salary of $10,000			
		ADI in 1995		ATE in 1995	
		Company A	Company B	Company A	Company B
5	Debt	0	$1,643	0	$46,977
5	Equity	0	1,643	0	46,977
5	ESOP loan	$1,162	2,780	$29,313	63,023
5	ESOP stock	1,036	2,325	26,432	52,789
5	ESOP Conv. from PSP		2,780		63,023
11	Debt	0	1,643	0	46,977
11	Equity	0	1,643	0	46,977
11	ESOP loan	632	2,300	31,512	67,243
11	ESOP stock	505	1,870	26,938	54,533
11	ESOP Conv. from ESP		2,300		67,269
30	Debt	0	1,643	0	46,977
30	Equity	0	1,643	0	46,977
30	ESOP loan	253	1,921	33,154	70,529
30	ESOP stock	202	1,541	27,216	55,569
30	ESOP Conv. from PSP		1,921		70,529
		Employee with 1976 Salary of $50,000			
		ADI in 1995		ATE in 1995	
		Company A	Company B	Company A	Company B
5	Debt	0	$8,213	0	$234,885
5	Equity	0	8,213	0	234,885
5	ESOP loan	$5,812	13,899	$146,566	315,117
5	ESOP stock	5,180	11,624	132,162	263,945
5	ESOP Conv. from PSP		13,899		315,117
11	Debt	0	8,213	0	234,885
11	Equity	0	8,213	0	234,885
11	ESOP loan	3,159	11,498	157,558	336,217
11	ESOP stock	2,527	9,350	134,689	272,663
11	ESOP Conv. from ESP		11,498		336,344
30	Debt	0	8,213	0	234,885
30	Equity	0	8,213	0	234,885
30	ESOP loan	1,264	9,603	165,771	352,643
30	ESOP stock	1,011	7,707	136,079	277,844
30	ESOP Conv. from stock		9,603		352,643

Two generalizations may be drawn from the data. First, for employees of both companies, the lower the P–E multiple at the time of the financing, the greater the ADI for all years and salary levels. Conversely, ATE was greater in all cases the higher the P–E multiple at the time of the financing. The final thing to note about the results is the very low level of ADI for the lower paid employees. The highest level it reaches in the company where addition plan contributions are required (which would be the situation for most companies) is $1.162. This is less than 5 percent of that employee's $25,270 salary in 1995 (assuming salaries are increased at a compound annual rate of 5 percent). Even the capital holdings are not very significant for this company, being just slightly greater than the employee's annual salary. Thus, it is highly questionable whether such plans would have much of an impact on employee motivation and ultimately the company's productivity.

Potential Impact on the National Economy

In the past few years, the implications of the ESOP concept for corporations and employees have been analyzed in depth. But the potential effects of the widespread adoption of ESOPs on the economy at large, involving capital formation and economic growth, has been neglected for the most part. Consideration of these factors should be an integral part of further congressional deliberations on legislation related to ESOPs.

Following is a preliminary assessment of the macroeconomic issue, beginning with the relation of ESOPs to the question of new capital formation, since their proponents have predicted that ESOPs will become the dominant form of financing for American business over the next decade. Basically, ESOPs would stimulate capital formation by reducing the cost of capital through their tax deduction features. The question is whether it is desirable to subsidize the cost of capital through ESOPs. This is particularly true in those cases where the ESOP obtains stock that cannot easily be sold in the marketplace. Under such circumstances, the ESOP may pay too high a price for the stock, and it is questionable whether the tax system should be used to induce the sale of such stock.

Furthermore, the reduced cost of capital does not result from any inherent provisions of the ESOP idea but simply results from a general policy that allows contributions to employee benefit funds to be tax deductible. Thus, if the primary objective is to stimulate capital formation through lowering the cost of capital, a similar effect could be achieved by many non-ESOP methods such as reducing the corporate income tax rate, increasing the investment tax credit, or liberalizing the accelerated depreciation allowance even further.

Widespread adoption of leveraged ESOPs, especially if accompanied by high economic growth rates, would contribute to inflation. The reasons for this were detailed in chapter 2's examination of the financed capitalist plan, which can be briefly summarized. The greatly expanded use of bank credit to finance new capital through ESOPs

would result in a large increase in the money supply that would be fed into a demand for goods and services immediately. This process of sending more money after the productive capacity is an engine of inflation. Such use of bank credit on a small scale would do no harm, but on a massive scale, inflation would be aggravated. Not to recognize this is to fall prey to the fallacy of composition.

A further question to consider is whether the second income that workers will receive through dividends paid annually on the stock allocated to them in the ESOT will play a vital role in increasing purchasing power to meet unsatisfied consumer desires. This is an important macroeconomic question, for there must be a demand for the greatly expanded output of goods and services, and the "second income" of workers is relied upon by ESOP proponents to initiate such demand. To determine whether this is a realistic expectation, one must first determine the significance of these second incomes. In this section we will ignore the actual experience with second incomes to date which, as appendix B indicates, is far from encouraging.

Rather, we will make the optimistic assumption that all corporate dividends would go to the workers as second incomes. If the total amount of such dividends in 1975 had been distributed evenly over a nongovernment work force of 91 million people, each worker's income would have increased by about $360. Most workers will not become too excited or motivated by such an increase, which even for the worker making $7,000 is only a 5-percent increase. Even under the most extreme case, which is Kelso's ultimate goal, where there is no corporate income tax and all earnings are fully paid out as dividends, this would still amount to only $1,283 per worker, who would inevitably face higher personal income taxes to make up for the loss of corporate income taxes.

A more sophisticated answer to the question of whether workers would earn an adequate level of second income from ESOPs depends on the following variables: (1) How much corporate investment is financed through ESOPs; (2) the rate of return on this new capital; (3) the corporate income tax rate; and (4) the level of second income considered to be adequate. Let us assume that $5,000 per household is an adequate second income and that the number of households participating in ESOPs remains constant at 50 million. Professor Buss has calculated the number of years it would take to reach this second-income level under three scenarios.[7]

Under the base case scenario, which essentially extrapolates past trends into the future, it would take 87 years; while under the very optimistic scenario, it would take 25 years. When the percentage of corporate investment was allowed to vary over time, increasing by 2 percentage points a year until all net corporate investment is ESOP financed, the $5,000 second income was attained in 30 years.

---

[7] Base case assumptions were: ESOPs finance 5 percent of net corporate investment which grows at 5 percent per year; the level of corporate investment initially was $50 billion; the before tax rate of return on corporate capital was 13 percent; the corporate tax rate is 50 percent.

Optimistic scenario assumptions: ESOPs finance 50 percent of net corporate investment continually; the initial level of net corporate investment and its annual rate of growth are doubled; the rate of return is 20 percent; the corporate tax rate is reduced to zero. Intermediate scenario assumptions: Corporate investment is initially $50 billion; it grows at 5 percent per year; the aftertax rate of return is 20 percent.

One must then consider how many in the labor force would actually be receiving this second income, assuming that all ESOP plans provided for annual dividends. As presently structured, only workers in private enterprises whose employers may issue stock could receive second incomes. Kelso's broader scheme does call for the eventual participation by all Americans, but this would take about 15 years before, as he says, "we could begin to experiment with the techniques to achieve this. Meanwhile, a substantial portion of the labor force would not even be eligible for such second incomes. First, as shown in table 10, there are 18.1 million members of the labor force who are not wage and salary workers. There is an even larger number of individuals who are wage and salary workers, but would not receive second incomes since they do not work for profit-making corporations—21 million. Thus, two out of every five people in the labor force would not even be eligible to receive a "second income" through the ESOP mechanism.

TABLE 10.—*Number of individuals not eligible to receive "second incomes"*

[February–April 1976 statistics]

	Millions
Nonwage and salary individuals:	
Armed Forces	2.1
Unemployed	7.0
Self-employed	5.6
Agriculture	3.4
Total	18.1
Wage and salary workers not in profit-making corporations:	
Federal Government	2.7
State and local govt	12.6
Education services	1.3
Medical and other health services	4.3
Nonprofit research	.1
Total	21.0

Finally, one must consider the potential amount of tax revenue lost under widespread ESOP adoption. This is very difficult to estimate as it involves not only the amount of taxes not paid by companies but the additional revenue that would come into the Treasury if the increased growth of the economy occurred as projected by ESOP proponents. The amount of additional revenue from this increased growth depends, as indicated in the discussion of the financed capitalist plan. on how fully employed the economy is. In an underemployed economy, the net revenue loss would certainly be smaller. Kelso, in fact, believes that the Government revenues lost will be "far more than offset" by the additional growth and employment generated. Nevertheless, the potential level of lost tax revenues is quite large and must be taken into account when considering further incentives to encourage ESOPs.

If all nonfinancial corporations had contributed 10 percent of their wages to ESOTs in 1975, total contributions would have been $56.9 billion. Claiming this as a deduction would have reduced the profits tax liability from its actual $35.9 billion to around $14 billion. Adding another $1 billion for the amount that could have been claimed if the 1-percent investment tax credit ESOP had been in effect the whole

year and fully utilized, reduces the tax liability to $13 billion. This is a dramatic 64-percent reduction in the revenue obtained from the corporate income tax. While not all corporations would contribute the maximum amount in the near future, the potential tax loss is very large and should be seriously considered in future legislation affecting ESOPs.

How ESOPs Should Be Governed and Structured

Before citing the specific provisions, the general point concerning ESOPs should be reemphasized. ESOPs are a useful device for broadening the ownership of stock and can also serve the purpose of providing an alternative financing mechanism for corporations. This does not mean that ESOPs are universally beneficial to all companies and employees, nor are they the only method that should be relied upon to broaden stock ownership. They do have the potential of benefitting a large segment of the American population by enabling eligible employees to own stock in their name, but there are millions who would not be eligible for such benefits under ESOPs which can only be utilized by stock issuing corporations in the private sector.

Government action could affect the future establishment of ESOPs in a number of ways. Most critical would be legislative incentives to encourage them and executive regulations regarding their structure. Our review of ESOPs concludes that no further legislative incentives are necessary, but that provisions should be established to regulate ESOPs. It is hoped that these recommendations will be taken into account by Congress in considering further incentives for ESOPs, as well as by the IRS in setting regulations.

Incentives

Congress is facing a decision on whether further incentives to adopt ESOPs should be legislated. Certain results of the Seeberg study cited earlier in this chapter are particularly relevant to this question. The study found that given current average P–E multiples, only the leveraged ESOP, where no additional contributions were required to implement the plan, proved acceptable in meeting the earnings per share and debt equity goals. On the other hand, where such additional contributions were required, ESOP techniques failed to produce acceptable increases at any of the three (5, 11 and 30) P–E multiples. Thus, the most efficient incentive at this time, if Congress determines that it wants to encourage more widespread use of ESOPs, would be a tax credit designed to equalize the status of corporations required to make such initial outlays with those that are not required to do so.

To accomplish this objective, the credit would be based on the difference in contributions deductible for the year in which the credit is claimed and the preceding taxable year. This difference would be increased or decreased in subsequent years based on a similar computation in each of these years.

The amount of the credit would be based on the employer's contributions of qualifying employer securities or cash when the cash is used by the trust to service its loan. This credit amount so established would be available for as long as the contributions received each year remained at the same level. If they increased or decreased, the credit

would be adjusted accordingly. If desired. the amount of the credit could be limited to a percent of covered payroll and/or gradually decreased, based on a percent of the credit available in the prior year, until it was reduced to zero after several years. Both of these limitations on the amount of the credit would serve the purpose of controlling the revenue loss to the Treasury.

This type of credit would not have the inherent limitations of two of the major ESOP incentives specified in the Accelerated Capital Formation Act of 1975: It is not limited, as the dividend deduction is, only to corporations paying dividends [8] and it is not like the charitable contribution deduction which is viable only for shareholders in the highest tax brackets. Additionally, the benefit of this credit is not limited to leveraged ESOPs as is the Kelso proposed discount of ESOP trust loans by the Federal Reserve. Finally, it is not like the tax credit available under the Tax Reduction Act of 1975 which benefits only corporations making substantial capital outlays. Thus. if further ESOP incentives are desired, this type of credit, covering all possible ESOP situations, should be considered.

Regulations

In order to assure that ESOPs are facilitating a genuine worker ownership, it should be required that the ESOP-acquired stock have voting rights equal to the voting rights of other employer common stock. Going this far, however, still falls short of giving the employees a voice in the direction of the enterprise which can only be achieved by procedures established for voting the stock. As appendix B indicates, most ESOPs have had their shares voted by an ESOP trustee who is closely associated with management. When this happens, the ESOP basically becomes a means of strengthening management's control rather than a method for increasing employee participation in the enterprise. Therefore, for all publicly held corporations, ESOPs should be required to pass through the voting rights on stock held by the trust to the employees.[9] This requirement should be limited to publicly held corporations in order not to discourage controlling shareholders of closely held corporations who may wish to transfer substantial portions of their equity to the trust but who do not wish to relinquish voting control. The ESOP participants could give the trustee voting instructions with respect to the shares allocated or vested in their individual accounts.

This mandatory pass-through requirement is already specified in two of the four congressional bills dealing with ESOPs discussed in appendix A—the Trade Act and the Tax Reform Act. More generally, the New York Stock Exchange has in the past encouraged the policy

[8] Some light can be shed on the question of whether or not a dividend deduction incentive should be provided by the following facts. The companies that would benefit most from such an incentive are those for which ESOP techniques did not prove acceptable in the Seeberg study, namely, companies whose stock was selling at a low P–E multiple at the time of contemplated financing. But, such an inventive would provide a windfall to companies where ESOP techniques proved acceptable under current tax law. Thus, it does not seem appropriate to provide this type of across-the-board incentives. If such a decision was made, however, the revenue loss might be reduced by conditioning the deduction on the pass-through of dividends to the employee-participants when paid.

[9] Kelso, in answering a question from the committee, said that he did not support mandatory pass-through voting, since if the employees desired it, it could be achieved now through collective bargaining. This argument holds for situations where the company is unionized and the unions plan an active role in helping to establish the structure of the ESOP. Unfortunately, this situation is simply not the usual case for companies with ESOPs as shown in appendix B.

of passthrough voting. Many corporations, such as Sears, Mobil, Ford, U.S. Steel, and Alcoa, apparently recognize the value of pass-through voting for it is included in their employee benefit plans.

There is a second provision that can help to prevent management's domination of the ESOT. At the minimum, an advisory committee elected by the ESOP participants should be established to assist the ESOP trustee. This committee could direct the trustee on how to vote trust shares not voted by employees under the pass-through voting system. Such committees do exist under current ESOPs, but they are usually management appointed. Employees' interests would be more effectively protected and promoted by a committee elected by employees. Both this provision and the passthrough voting provision should be integrated by the Treasury Department into the tax definition of an ESOP.

Two further recommended changes involve ceilings on contributions. The first would be to remove the limitations on contributions to ESOPs (15 percent of covered payroll, 25 percent if money purchase plan is included) provided that the ESOP has been established for purposes of corporate expansion. The second is that a ceiling of $500,000 on the amount of stock allocated to an employee's account should be imposed.

A final recommendation is that ESOPs should be allowed to diversify, much like a mutual fund. This would be of general benefit, for the diversification of holdings reduces the risk of particular stock investments and, as indicated earlier, helps to increase productivity throughout the economy by increasing the mobility of capital and labor. It also would help ameliorate the risk of employees losing everything if their company goes bankrupt or experiences a serious decline.

There are other matters relating to ESOPs which we view as favorable, but would not recommend that they be made part of the law. First, dividends should be passed through to the beneficiaries on an annual basis to the greatest extent possible. Second, vesting schedules should be shortened, with the possibility of immediate vesting being considered for the employees, so that they will be true owners of the corporation in as short a time as possible. Third, consideration should be given to having ESOPs arrange loans to employees for their own investments.

These recommendations are summarized as follows:

In order to increase employees' interests in such plans and to better insure that they will definitely benefit the employees, it is recommended that the following provisions be made part of the law governing ESOPs and the incentives for their adoption: (*1*) *All stock held by the ESOT should have voting rights equal to the voting rights of other employer common stock, and for publicly held corporations, these rights should be passed through to the employees;* (*2*) *an advisory committee to the ESOP trustee should be established by vote of the employees;* (*3*) *the curent limitation on annual corporate contributions to the ESOT should be removed provided that the funds channeled through the ESOT are used for corporate expansion;* (*4*) *a ceiling of $500,000 should be imposed on the amount of stock which can be allocated to an employee's account in an ESOT;* (*5*) *ESOTs*

should be allowed to trade in the stock of other companies up to a certain percentage maximum. Though not recommended as part of the law governing ESOPs, the following actions should be practiced whenever feasible: (1) Annual distribution of dividends to the employees; (2) shortened vesting schedules; and (3) provision of loans to employees by the ESOT.

Further incentives for the establishment of ESOPs are not needed at this time. However, if Congress wishes to provide such incentives, they should be more specifically targeted to insure that companies which would already be attracted to ESOPs do not unnecessarily benefit from further incentives. One method meeting this criteria would be a tax credit or deduction based on the amount of additional contributions required in the year of the financing to implement the ESOP, with the credit or deduction gradually decreasing to zero over a given number of years.

Appendix A. LEGISLATIVE INCENTIVES FOR ADOPTING ESOPs

Though the ESOP concept has been utilized by companies over the past two decades, there were no legal definitions or regulations pertaining specifically to ESOPs. It was not until December 1973 that a congressional bill specifically defined an ESOP. Since then, three other bills have included definitions of, as well as various incentives for, ESOPs. The ESOP-related provisions of these bills will be highlighted.

The first bill to legally define an ESOP was the Regional Rail Reorganization Act of 1973. The original Senate version of the bill would have required the new Consolidated Rail Corp to meet its capitalization requirements as much as it could through the use of an ESOP.

The final bill was much less forceful ("giving the corporation authority to purchase its common stock through an ESOP"), but the Senate definition of an ESOP as a "technique of corporate finance" was adopted. Senator Long, who was instrumental in having the ESOP provision inserted, firmly believed that ESOT financing was the only alternative to nationalizing the railroads, since it was only by acquiring a stake in capital ownership that railroad workers would be sufficiently motivated to put the carriers on a paying basis.

The second bill impacting on ESOP was ERISA which for the first time provided a definition of ESOPs that was to be added to the Internal Revenue Code. This act also singled out ESOPs as the only employee benefit plan which can be used as a vehicle for corporate borrowing and other debt financing. In general, special treatment was accorded ESOPs in the sections setting forth standards of conduct for plan trustees and administrators.

Basically, ESOPs are exempted from: (1) the requirement for diversification of plan assets; (2) the requirement that not more than 10 percent of plan assets be invested in employer securities and employer real property; and (3) the prohibition of party-in-interest transactions[1] as applied to a loan to an ESOP providing the loan is primarily for the benefit of participants and beneficiaries and does not carry an excessive rate of interest. It should be remembered, however, that these and other special privileges allowed an ESOP do not change the fact that the plan be primarily for the benefit of participants.

The next major piece of legislation that included ESOP provisions was the Trade Act of 1974. Federal guarantees for loans made to companies in geographical areas adversely affected by increased imports were provided. The Secretary of Commerce is required to give preference for these loan guarantees to corporations which agree to place 25 percent of the loan into a qualified trust under an ESOP. Once again, ESOPs were defined as a technique of corporate finance.

The most recent piece of legislation to provide incentives for the establishment of ESOPs was the Tax Reduction Act of 1975. This Act did much more to stimulate interest in ESOPs than the first three bills, and the action taken on the question of extending the temporary ESOP-related provisions contained in this act will be critical in determining the extent to which ESOPs will be utilized by corporations over the next few years.

Having increased the investment tax credit from 7 percent to 10 percent for 1975 and 1976, the act also provides an additional tax credit of 1 percent of the

---

[1] A party-in-interest is defined in Section 3 (14) of ERISA and includes any fiduciary person providing services to the plan, and employer whose employees are covered by the plan and employee organization whose members are covered by the plan, as well as other closely conntected individuals. Section 406 prohibits all party-in-interest transactions, which are defined to include: The sale or exchange or lease of any property between the plan and the party-in-interest; the lending of money or other extension of credit between the plan and the party-in-interest: the furnishing of goods, services or facilities between the plan and the party-in-interest, etc.

corporation's qualified investment if the amount is transferred to an ESOP. In effect, the company is giving this amount to their employees instead of the government which means that the cost of these contributions will be borne entirely by the Government.

The act added nothing new to the definition of an ESOP except that profit sharing plans may be considered to be ESOPs. The act, however, listed a host of additional requirements that ESOPs had to meet in order to attain the tax credit, including full vesting at all times of participants' accounts and allowing participants to direct the vote of the shares in their account.

The real significance of this act for ESOPs is that it sparked the interest of many large corporations in the ESOP concept since a large dollar amount could be involved. Before this time, ESOPs had primarily been implemented by small, privately-owned corporations. Since it is tied to the investment tax credit, this act discriminates in favor of capital-intensive companies because significant labor intensive companies may find that the credit is not very significant as a percentage of the total wage bill, even though the dollar sums are substantial.

It should be noted that legislation could be passed at other levels of government to promote the adoption of ESOPs. Such legislation was in fact enacted for the first time in Minnesota in March 1974, but none has been added since that time. Minnesota's legislature believed that encouraging employee stock ownership would benefit the people of the State by helping to achieve five lofty goals.[2]

There were two innovative features related to ESOPs contained in this law. One is that ESOTs can be treated as charitable organizations for purposes of State inheritance and gift tax law. The second requires that an advisory committee must be elected by the ESOP participants to assist the ESOP trustee. This requirement restricts management's ability to dominate the ESOT.

---

[2] The five goals were: 1) renewing and enlarging sense of the worth of human effort; 2) recognizing the interdependency of human effort and the ownership of the productive assets with which people work; 3) providing direct economic advantage to employees from increased productivity; 4) reducing differences in the real interests of labor and capital and 5) relieving a primary cause of social tension and alienation.

Appendix B. EXPERIENCE WITH ESOPs

There is wide agreement that the first ESOP of the type analyzed in this report was established in 1957 by Peninsula Newspapers, Inc., to avoid a takeover by another newspaper chain. No such agreement can be found on experience with ESOPs since that time, especially regarding the number which have been established. Estimates range from 200 to 500; the Treasury Department cited 300 at the December hearings. Even this estimate cannot be considered an accurate approximation, for as they have acknowledged in a letter to the committee: "Until these newly required standardized forms come into the IRS, the overall number can only be crudely estimated."

Fortunately, some precise information established from small sample surveys conducted in the past year, is available on various ESOPs. Basically, these surveys confirmed postulates in chapter 3 as to which types of companies would find ESOPs most attractive and what structure their ESOPs would take. In general, most were adopted by small, closely held companies engaged for the most part either in services or light manufacturing. For example, the most recent survey found that 1975 revenues were less than $100 million for 13 of the 17 companies surveyed, while 12 of the companies had less than 1,000 employees. Their services covered such areas as retailing, distributing, advertising, securities and insurance.

These surveys clarify for what purposes ESOPs have been established. In a 10-company survey, all companies listed "increasing employee incentive" as a reason for establishing their ESOP. Eight of the companies cited another strong reason for adoption (not stressed by ESOP proponents)—either to "provide a retirement benefit" or "supplement their pension plan." The other survey actually made clear that 5 of the 17 companies had established their ESOP in lieu of a pension plan. Only half of the companies in each of the surveys used ESOPs as an alternative means to finance corporate expansion; in other words, used a leveraged ESOP. Other reasons cited by one or two companies in the two surveys were: to provide an estate planning mechanism for a major shareholder; to qualify the company for the extra 1 percent investment tax credit; to turn over the company 100 percent to the employees; to create a tax loss, allowing recapture of about $750,000 in back taxes; to conduct a joint tender offer with the aim of going private; to purchase the company from a controlling shareholder; and to spin off a subsidiary to employees. This list, taken from just a small sample of companies, clearly indicates that ESOPs can serve many purposes and that in general, its use as a technique of corporate finance, so heavily stressed by its proponents, is just one among many from the corporate perspective.

The surveys also examined the structure of ESOPs, particularly as to the extent of participation and benefit by employees. The 17-company survey found that in only 3 companies were less than 60 percent of the employees in the ESOP, but on the other hand only 4 companies had greater than 90 percent participation. The results in the 10-company survey were very similar, for an average 69 percent of the employees were participants in the plans, 2 companies had less than 60 percent participation and only 1 company had 100 percent participation. It should be noted that the lowest participation rate (27 percent) was found in the only plan requiring employee contributions for participation.

Voting rights on stock held by the ESOTs were found in 80 percent of the plans in the 10-company survey, but only 20 percent of the plans allowed employees to vote the stock held by the trust. Pass-through voting was greater in the other survey, with 7 of 17 companies allowing such rights to vested employees. A majority of the plans provided vesting at 10 percent per year of participation.

A very significant finding among the 10 companies in one survey was that although 6 of the ESOTs held dividend-paying stock, none of the plans provided for such dividends to be "passed through" the trust to the employees as a form of second income. This makes highly questionable the alleged beneficial economic effects of Kelso's second-income plan.

The 10-company survey showed that the percentage of the ESOTs' funds currently invested in employer securities ranged all the way from 20 percent to 100

percent, with just half of the companies reporting nearly complete employer securities investment. The other survey also yielded some insight into how significant were the ESOTs stockholding relative to total outstanding issues. This relates to the issue of voting rights, as many corporate managements are fearful of losing control of the direction of the company through majority employee control. Judging from this survey, they have little to fear at present for at the end of 1975, only 2 of 17 ESOTs held more than 50 percent of the corporation's stock. One of these cases was South Bend Lathe which was a company salvaged through transferring it to the employees through an ESOP, while the other case was also an ESOT established to borrow money to purchase the company from a controlling shareholder. Thus, ESOPs may lead to employee control if desired but certainly do not have to, a point which should be obvious since their use and growth is basically under the management's control.

Two sections of chapter 3 showed that ESOPs have not been adopted widely and that when they have been used, it is usually by a small, closely held company which engages an ESOP for a variety of reasons besides corporate finance. Larger, publicly held companies have not been attracted to ESOPs because they often have large retained earnings and good credit and hence have little need for such a program to aid in the financing of growth. For them, standard financing techniques are available, often at a lower cost of capital than under an ESOP program. Also, such large corporations usually have to negotiate employee benefits with unions which have shown no real enthusiasm for these plans. Additionally, being a public company exposes them to legal hazards that a closely held company need not fear. Certainly the possibility of shareholder suits has been one negative factor weighed by public companies. With regard to ITC–ESOPs, such companies are reluctant to start a benefit program that will be difficult to discontinue if the Government's 2-year contribution in the form of a 1-percent credit does come to an end. (If the 2-year period were extended, many of the large, capital-intensive public companies would definitely be more interested.) Thus, the short period of applicability as well as the requirement of immediate vesting and a pass-through of voting rights have delivered a double-barreled punch to inhibiting the adoption of ITC–ESOPs.

Other factors have contributed to the slow adoption of ESOPs. There is a skepticism on the part of companies over just how much increased motivation and hence productivity can be gained by implementing an ESOP. Many feel that they would have to contribute a fairly substantial portion of their payroll and then wait for a lengthy period before any positive results could be noticed. This is an expensive undertaking for an unsure result, for as one witness said at the December hearings in regard to his clients: "There is only a hope on the part of the ownership interests that the productivity of their workers will increase as a result of the establishment of an ESOP."

Relatedly, the company must either have or anticipate imminent healthy profits. It would be foolish for companies with an uncertain profit future to pledge an annual contribution to an ESOT which must be paid regardless of the profit picture over a given number of years. Also, the success of the plan could well depend on the payment of dividends, but companies most willing to pay dividends, those that are established and stable, generally have resources available to meet their modest growth financing needs.

Other factors which could enter into the decision by a corporation on whether or not to adopt an ESOP include the additional overhead for educating employees on the operation of both the trust and the company, which smaller companies cannot afford. Furthermore, many smaller companies are being built with ultimate merger or corporate sale in mind. The possibility of a change in the value of stock at merger might heighten employee discontent with the decision to merge. In general, companies are leery of the lack of clear and final regulations from the IRS with regard to ESOPs. Companies may be particularly fearful of the final ruling and interpretation of what it means for these plans to be for the "exclusive benefit of the employees" when the company so clearly will also benefit.

In conclusion, ESOPs have not been widely adopted to date and those that have been were instituted mainly by small, closely held companies for a variety of reasons, among which corporate financing for expansion was not dominant.

Appendix C. JAVITS-HUMPHREY "EMPLOYEE STOCK OWNERSHIP FUND ACT OF 1976"

The committee's senior members, Senators Hubert H. Humphrey and Jacob K. Javits, have continued to explore and examine various methods to facilitate the broadening of stockownership by American workers for the mutual benefit of labor, management, and the domestic economy. As a result, Senators Humphrey and Javits together have developed a unique legislative initiative to bring employee stockownership into the collective bargaining process by facilitating labor-management negotiation of employee stockownership trust funds.

With very few exceptions stockownership and stock purchase plans have not received the attention of the union-organized sector of the economy. There are numerous reasons why stockownership plans and fringe benefit incentive programs have not surfaced at collective bargaining tables. Most ownership programs have been established for the sole benefit of managers and supervisors.

More importantly, many such plans fail to contain adequate safeguards to insure that the legitimate concerns of rank and file employees about stockownership are addressed. For example, employees are circumspect about plans that purport to offer enormous financial benefits, while their direct participation in such plans is limited.

In short, existing plans have circumvented the process of labor-management collective bargaining negotiation which is the centerpiece of our national labor policy designed to provide for the peaceful determination of wages, hours. and working conditions. Collective bargaining is the tried and true mechanism through which organized labor and management have worked together at the bargaining table to establish communication lines and to negotiate wages and fringe benefits as well as solve labor-management disputes. Collective bargaining has proliferated as the major means of determining wages in our organized industrial sector in such areas as manufacturing, entertainment, communications, health care, et cetera. If we expect to achieve the advantages of broadened stockownership among organized labor in the United States, it is necessary that legislation containing specific employee safeguards be designed to be compatible with the principles of collective bargaining enunciated in the National Labor Relations Act.

The legislation initiative introduced by the chairman and the ranking Republican is the first such legislation to facilitate employee stockownership among organized labor. It is designed to address the concerns expressed by organized labor and management that the actual stock benefits not be illusory.

The American economy continues to be beset by the extremely complex and difficult problems of lagging productivity and inadequate capital formation. These can only be resolved by way of long-term broad-based planning and creative new initiatives which can foster further economic and social development of American capitalism. Such is the goal of S. 3300.

The legislation is designed also to reverse some disturbing trends concerning stockholding by individual Americans which were outlined in chapter 1. In order to reverse these trends and truly democratize the ownership of stock in this country a mechanism should and must be established which meets the concerns of organized labor and which can be looked upon by both labor and management as a valuable and safe new employee fringe benefit for active negotiation at the collective bargaining table.

S. 3300 does a number of things to increase the attractiveness of employee stockownership for both organized labor and management. The bill expands the Taft-Hartley Act provisions which allow the formation of jointly trusteed pension funds, health and welfare fund, and legal service funds to permit the establishment of a jointly trusteed trust fund for investment in stock for the

benefit of bargaining unit employees. This will allow individual labor unions through collective bargaining, to determine whether they would like to have equal representation with management as stockownership fund trustees. Moreover the legislation allows the trustees of an employee stockownership trust fund to invest up to 30 percent of the funds in the employer's coporate stock. The bill specifically allows trustees to consider the productivity and employee morale advantages of investment in the employer stock in addition to the time-tested financial criteria utilized by trustees generally. Finally the legislation precludes the establishment of stockownership funds under these Taft-Hartley provisions if the employer has not already negotiated a pension plan. This would prohibit the termination of pension plans and the substitution of stockownership plans.

The stockownership plan framework designed under the bill is to be viewed as a new employee fringe benefit but not as one for future pension planning. The legislation is intended to inject a bold new initiative into labor-management negotiations and thus to enhance collective bargaining for the ultimate benefit of labor, management, and the economy in years to come.

[The text of the bill and a summary of its major elements follow:]

S. 3300

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this act may be cited as the "Employee Stockownership Fund Act of 1976."

SEC. 2. (a) Title III of the National Labor Relations Act is amended by adding after section 302 the following new subsections:

"EMPLOYEE STOCKOWNERSHIP TRUST FUNDS

"SEC. 303. (a) Except as otherwise provided in this section, the provisions of section 302 shall not apply with respect to an employee stockownership trust which is established after the date of enactment of this section and administered by an equal number of representatives of the employees and the employer together with such neutral persons as the representatives of the employees and representatives of the employer may agree upon and meets the requirements of this section.

"(b) A trust established under this subsection shall;

"(1) be subject to the requirements of clause (b) of the proviso to clause (5) of subsection (c) of section 302;

"(2) prohibit the expenditure of trust funds for any expenses other than:

"(A) corporate stock with voting rights for which a registration statement has been filed with the Securities and Exchange Commission, and fixed income securities; and

"(B) reasonable administrative costs;

"(3) provide for the investment of the trust funds in corporate stock with voting rights and fixed income securities selected by the trustees: *Provided,*

"(A) that the trustees in the exercise of their discretion may invest up to 30 percent of the trust funds in the corporate stock of the employer; *and further provided:*

"(B) that the trustees shall consider the productivity and employee morale advantages of investment in the corporate stock of the employer in addition to the financial considerations of safety, income, and appreciation in determining the size of such investment.

"(4) provide that an employer contribution may not be withdrawn from the trust prior to the expiration of 3 years from the date such employee commences participation in such trust except with the approval of the trustees in a case of disability or death;

"(5) provide that any employee who has participated in such trust for a period of 3 years shall have a nonforfeitable right to 100 percent of the securities bought and held by the trustees as a result of the employer contributions made to the employee's account;

"(6) provide that any nonforfeitable rights accruing to a participant shall not revert to the employer, a union under any circumstance: and that forfeited rights in the fund shall be distributed by the trustees to all remaining participants annually.

"(c)(1) The provisions of this section shall not apply to a trust under this section unless the employer has in effect, at the time a trust is established under this section, a qualified employee pension benefit plan as defined in section 3(2) of the Employee Retirement Income Security Act of 1974.

"(2) Withdrawal or termination from participation in a qualified employee pension benefit plan, shall also be deemed a withdrawl from a trust established under this section.

"(d) Section 303 and 304 (and all references thereto of the National Labor Relations Act) as in effect on the day prior to the date of enactment of this act are redesignated as sections 304 and 305 respectively."

Summary of Major Elements of Javits-Humphrey Employee Stock Ownership Fund Act of 1976

The Javits-Humphrey legislative initiative will provide a new framework for broadening stockownership to the rank and file members of organized labor and facilitate negotiations for an employee "share in the American capitalist system" for the mutual benefit of labor, management and domestic economy. The legislation contains the following principle elements:

Expansion of existing National Labor Relations Act provisions that permitted establishment of jointly administered labor-management pension, and health and welfare funds, to further permit establishment of jointly trusteed employee stock-ownership trust funds, through voluntary collective bargaining negotiations.

Discretionary authority for prospective boards of trustees of employee stock-ownership trust funds to invest up to 30 percent of the trust fund in the corporate voting stock of the employer. The remaining portion of the fund is to be diversified in a corporate stock and fixed income security portfolio to be selected and overseen by the board of trustees.

Preclude establishment of stock ownership trust funds under the National Labor Relations Act unless the employer already has in effect an employee pension benefit plan qualified under ERISA.

Provide for mandatory 100 percent vesting after 3 years of employee participation.

O